Comptroller of the Currency
Administrator of National Banks

SPECIAL ANNIVERSARY ISSUE

Quarterly Journal

1981 - 1991

Office of the Comptroller of the Currency
September 1992

Comptroller . . . . Stephen R. Steinbrink (Acting)

Comptrollers of the Currency, 1863-1992

Hugh McCulloch	1863-1865	D.R. Crissinger	1921-1923
Freeman Clarke	1865-1866	Henry M. Dawes	1923-1924
Hiland R. Hulburd	1867-1872	Joseph W. McIntosh	1924-1928
John Jay Knox	1872-1884	John W. Pole	1928-1932
Henry W. Cannon	1884-1886	J.F.T. O'Conner	1933-1938
William L. Trenholm	1886-1889	Preston Delano	1938-1953
Edward S. Lacey	1889-1892	Ray M. Gidney	1953-1961
A. Barton Hepburn	1892-1893	James J. Saxon	1961-1966
James H. Eckels	1893-1897	William B. Camp	1966-1973
Charles G. Dawes	1898-1901	James E. Smith	1973-1976
William Barret Ridgely	1901-1908	John G. Heimann	1977-1981
Lawrence O. Murray	1908-1913	C.T. Conover	1981-1985
John Skelton Williams	1914-1921	Robert L. Clarke	1985-1992

Background

The Office of the Comptroller of the Currency (OCC) was established in 1863 as a bureau of the Department of the Treasury. The OCC is headed by the Comptroller who is appointed by the President, with the advice and consent of the Senate, for a 5-year term.

The OCC regulates national banks by its power to:

- Examine the banks;
- Approve or deny applications for new charters, branches, capital or other changes in corporate or banking structure;
- Take supervisory actions against banks that do not conform to laws and regulations or which otherwise engage in unsound banking practices, including removal of officers, negotiation of agreements to change existing banking practices, and issuance of cease and desist orders; and
- [illegible]

[illegible]

The Comptroller

Stephen R. Steinbrink has been Acting Comptroller of the Currency since March 1, 1992.

By statute, the Comptroller serves a concurrent term as a Director of the Federal Deposit Insurance Corporation and the Neighborhood Reinvestment Corporation. The Comptroller also serves as a member of the Federal Financial Institutions Examination Council.

Mr. Steinbrink joined the OCC in 1967 in Kansas City, Missouri and was commissioned as a National Bank Examiner in 1970. In 1983, he was appointed Director for Bank Supervision, Regional Banks for the Southwestern District Office. Prior to his appointment as Acting Comptroller of the Currency, he also served as Deputy Comptroller for Multinational Banking and Senior Deputy Comptroller for Bank Supervision Operations.

Mr. Steinbrink is a native of [illegible], Nebraska, and is a [illegible] graduate of the University of Nebraska.

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Quarterly Journal

Office of the Comptroller of the Currency

Stephen R. Steinbrink

Acting Comptroller of the Currency

The Administrator of National Banks

Comptroller of the Currency
Administrator of National Banks

Washington, D.C. 20219

October 6, 1992

To our readers:

Ten years ago we began publishing the *Quarterly Journal* as the official journal of record for the Office of the Comptroller of the Currency (OCC). Then, as now, it contained the OCC's most significant actions and policies, material previously published in annual reports, testimony and speeches presented on behalf of the agency, and other articles and material of interest to the national banking system.

Today we are pleased to send you a copy of this special anniversary edition of the *Quarterly Journal* covering the years 1981-1991. During these years, changes brought about by banks, their competitors, their regulators, and Congress were so profound that the commercial banking system at the beginning of the 1990s is fundamentally different from what it was in 1981. This anniversary issue offers us an opportunity to look back at the last decade to examine these changes. We hope that this review will provide a valuable perspective on what happened, as well as some important lessons for the future viability of the system.

In the 1990s, the national banking system will undergo more change. We are already implementing legislation so sweeping that it rivals legislation enacted in the 1930s. The FDIC Improvement Act of 1991 will significantly affect bank operations and the ability of banks to meet the needs of the U.S. economy, as well as their ability to compete domestically and abroad. Banks and their regulators will face the challenge of making these changes to help the banking system return to a stable condition.

We believe this issue of the *Quarterly Journal* will be both useful and informative. If you have comments or questions, please send them to the Communications Department, Office of the Comptroller of the Currency, Washington, D.C. 20219.

Sincerely,

Stephen R. Steinbrink
Acting Comptroller of the Currency

Contents

The Office of the Comptroller of the Currency and the National Banking System, 1981-1991

In 1981, former Comptroller of the Currency John G. Heimann wrote: "...The business of providing financial services will not only be different in the 1980s but significantly more difficult and challenging. It will be uncertain, more complex, intensely competitive, and will involve far greater potential for error." How did the national banking system fare during the years 1981 to 1991? What role did the Office of the Comptroller of the Currency (OCC) play?

This special issue of the *Quarterly Journal*, published to commemorate its tenth anniversary, attempts to provide some answers. As the federal agency responsible for the supervision of national banks, the OCC was a key player in the government's response to changes occurring in the marketplace and to implementing measures enacted by Congress affecting national banks. This issue draws together for the historical record articles, reprints of speeches and testimony, and statistical data highlighting some of the major developments in which the OCC and the national banking system participated.

During the 1980s, the environment in which national banks and, indeed, the entire commercial banking system operated can be described in terms of contrasts. During the decade, certain banks experienced devastating results one year but posted record profits the next. Banks in certain regions of the United States struggled to absorb nonperforming agricultural, energy, and commercial real estate credits, while others took advantage of interstate banking compacts to build regional organizations that challenged the multinational banks. Advances in telecommunications technology and product innovations made banking more convenient to customers but also provided nonbank competitors with the wherewithal to compete directly with banks.

Other changes so profoundly altered the nature of banking in the U.S. that pre-1980 banking seems antiquated today. Deposit deregulation allowed banks to substitute marketplace rates of return in place of "gifts" such as toasters or glassware to attract depositors. Automatic teller machines — now found in banks, grocery stores, shopping malls, and on street corners — provided depositors throughout the country ready access to their cash. Adjustable rate mortgages benefited financial institutions because the borrower shares some of the interest rate risk with the lender, while also providing home buyers an alternative mortgage instrument with more flexible down payment terms. Commingled investment retirement accounts provided individual investors with diversified investment opportunities by pooling their investments with those of others.

Changes in the business of wholesale banking also occurred in the 1980s. At the beginning of the decade, commercial and industrial lending was the most important and profitable type of lending for commercial banks. Off-balance sheet products such as options, futures, and swaps barely existed. A secondary market for securitized assets was in the formative stages. Innovations such as swapping nonperforming sovereign debt for equity investments in a foreign country had not been conceived.

During the decade competition intensified, and the once clearly separated lines between commercial banking, investment banking, and commerce blurred. Retail outlets, commercial enterprises, and securities firms began offering bank-like products to consumers and businesses. The commercial paper market continued to supplant banks as a source of funds for banks' best customers. Foreign bank penetration of the U.S. commercial banking market reached unprecedented levels while U.S. banks lost market share abroad.

A series of crises also occurred: more thrift and bank failures during this single decade than in the preceding four decades combined; the insolvency of the savings and loan insurance fund; and the depletion of the federal bank insurance fund. The reputation of the financial services industry was tarnished by scandals involving insiders at savings and loan, investment firms, and banks.

Federal regulation and supervision of the financial services industry also underwent far-reaching changes. At the beginning of the decade deregulation, or easing outmoded restrictions on banks and savings and loan associations, was the prevailing philosophy in the executive branch and among leaders of both parties in Congress. In 1982, the Garn-St Germain Act significantly expanded the investment authority for savings and loans and increased national bank lending opportunities by raising the legal lending limit. By the end of the decade, the mood had shifted radically. In 1991, Congress enacted the Federal Deposit Insurance Corporation Improvement Act (FDICIA), which imposed significant restrictions on bank operations and required federal regulators to take "prompt corrective

actions against troubled institutions to ensure that the Bank Insurance Fund would not have to be replenished by the taxpayer.

This anniversary issue of the *Quarterly Journal* begins with an article tracing the OCC's supervision of national banks from 1863 to 1980. The OCC's mission during these years was essentially the same as it is today: to promote the safety and soundness of the national banking system and, within the confines of the law, to allow marketplace innovations that permit healthy competition and promote healthy institutions. Depending on the circumstances in which national banks were operating, the OCC sometimes emphasized promoting competition between national banks and their competitors, and, at other times, stressed fundamental principles of safe banking.

An article on the operations of national banks from 1981 to 1991 analyzes changes to the structure of the industry, its performance, and new developments in the business of banking during these years. It describes how bank failures and mergers, acquisitions, and reorganizations consolidated the system. It traces the development of credit quality problems in national bank loans for agriculture, energy, commercial real estate, and developing countries and shows how these problems affected the profitability of the system. The article reviews new developments in the business of banking, such as off-balance sheet activities. It also discusses changes in the capitalization of national banks.

The challenges facing the national banking system in the 1980s led to changes in the OCC's supervision of and enforcement actions against troubled national banks. The article on the the OCC's special supervision and enforcement activities traces strategies developed by the OCC during the decade to deal with the increasing number of troubled national banks. It discusses OCC initiatives to identify common deficiencies in troubled institutions and to provide guidance to bank officers and directors about signs of potential problems that could erode the safety and soundness of a bank. In the section on enforcement activities, the article summarizes significant developments in the OCC's enforcement authority in areas such as insider abuse, capital adequacy, and securities law violations. It describes cooperative efforts in which the OCC participated to combat bank fraud. It summarizes legislation enacted during the period that significantly expanded the enforcement authority of the OCC and other financial institution regulators. The article concludes with a section discussing changes to expedite the closing of insolvent national banks and litigation in which the OCC defended its enforcement policies in court.

The OCC was also an active player in reviewing and approving new activities and structural innovations developed by national banks to respond to marketplace competition. The article on this subject describes the OCC's role in approving investment products and services for national banks including discount brokerage and investment advice, annuities, and securitized assets. Since these actions also resulted in substantial amounts of litigation challenging the OCC's authority to approve these activities, the article also summarizes litigation involving the OCC. It highlights changes to the structure of the national banking system which also resulted in legal challenges, such as expanded branching opportunities and the permissibility of automated teller machines. The article also describes other events and developments involving the OCC and national banks that raised important legal issues, such as capital adequacy, legal lending limits, and debt-equity swaps of troubled sovereign debt.

This special issue also includes reprints of speeches and testimony presented by Comptrollers of the Currency and other senior OCC officials from 1981 to 1991. One section includes material tracing the OCC's supervisory and examination philosophy during these years. The section on the OCC's supervisory policies begins with testimony presented by Comptroller of the Currency John G. Heimann, who ended his tenure in 1981, and includes testimony and speeches presented by the two other Comptrollers serving during this period, C.T. Conover (1981-1985) and Robert L. Clarke (1985-1992).

A second section highlights significant issues in which the OCC and national banks were involved. Speeches and testimony in this section include material relating to the sovereign debt crisis, Penn Square Bank of Oklahoma City, problems faced by agricultural banks, the OCC's bank failure study, highly leveraged transactions, and risk-based capital. A comprehensive index to all of the OCC's speeches and testimony published in the *Quarterly Journal* during these years is also included.

Patricia B. Eggleston
Communications Department

The Office of the Comptroller of the Currency and Supervision of the National Banking System, 1863-1980

Since its creation in 1863, the Office of the Comptroller of the Currency (OCC) has strived to maintain the strength and stability of the national banking system in the face of competition from state-chartered banks and nonbank institutions. To meet this challenge for the financial services market, the OCC and the national banks have periodically had to reassess their standards of safety and soundness. This article examines the OCC's efforts to find the proper balance of soundness and competitiveness during the first century of national banking in America.

Introduction

That the new national banking system would replenish the United States treasury, which desperately needed it in 1863, no one doubted. According to the National Currency Act of that year, the newly chartered national banks would buy government bonds, deposit them with the system's caretaker, the Comptroller of the Currency, and be permitted to issue national bank notes equal to 90 percent of the bonds' face value.

But what did the future hold for the national banks themselves? Some predicted that the prestige of the national charter and the power to issue the new national bank notes would be advantages with which no state charter could compete. Proponents of national banking concluded that many state-chartered banks would avail themselves of the opportunity to convert from state to national charter; eventually, all would.

Yet even the most optimistic supporters of the new system acknowledged that at the beginning, at least, some state bankers would choose not to convert. Patriotism aside, why should they? The best state banks were already profitable enterprises that issued their own notes and enjoyed congenial relations with their local regulators. In contrast, inspired by the singularly tough laws of the State of New York, from which Congress had borrowed liberally, the National Currency Act imposed stiff capital and disclosure requirements, periodic examinations to be conducted by the OCC, restrictions on loans secured by real estate, and loan limits to individuals. The National Currency Act also required that banks converting to federal supervision forfeit their former corporate identities. Henceforward such banks would be known anonymously as the First or Second or Third national bank of their home towns. This last requirement caused as much grumbling as the more tangible provisions of the law, but Treasury Secretary Salmon P. Chase (1861-64) rejected the complaints, demanding uniformity in nomenclature and conformity overall in the new system.

By such policies, the administration of Abraham Lincoln sent the message that safety, soundness, and even austerity were to become the hallmarks of the national banking system. In his famous 1864 circular to national bank managers, Hugh McCulloch (1863-65), the first Comptroller, gave clear voice to these conservative principles: "Nothing should be done to foster speculation," he advised; "discounts should be made on as short a time as the business of the customer will permit"; "if the bank has any reason to distrust the integrity of a customer, close his account." Although this cautiousness was beneficial for the nation's credit and money, most financial entrepreneurs of the 1860s preferred the status quo and the more relaxed environment of state banking law.

Not surprisingly, after a flurry of new charters and conversions from state charters, enthusiasm for the national banking system dipped alarmingly. In his second annual report to Congress (1864), Comptroller McCulloch announced that his "apprehensions of a too rapid increase of national banks" had proved unfounded. In fact, he admitted, the new system had fallen short of expectations. After almost two years in operation, national banks were still outnumbered by state-chartered institutions more than two to one. Total capital held by national banks amounted to barely one-third of that held by state-chartered banks, a group which still included the biggest banks in the land.

In response, McCulloch urged Congress to amend the National Currency Act. Written in haste to avert the Treasury's wartime cash flow crisis, the 1863 law contained numerous ambiguities that required rectification. But McCulloch also recommended a series of substantive revisions in the law designed to make conversion to a national charter more attractive. He recommended that the statutory loan limit to individuals be lifted, leaving that question to "the discretion of the managers of the banks." Reporting requirements were to be eased. He sought to close a loophole under which state banks, having bought and deposited U.S. bonds, were receiving and issuing national bank notes; in the future, national banks and they alone would exercise that privilege.

Congress agreed. On June 3, 1864, it passed the National Bank Act, embodying most of McCulloch's recommendations for revisions in the National Currency Act, as well as a few of Congress's own ideas. Nine months later, in March 1865, Congress imposed a 10 per cent tax on the note issues of state banks, thus substantially reducing the value of a state bank charter.

As a result, by 1866, fewer than 300 state banks continued in operation. Freeman Clarke, who succeeded McCulloch as Comptroller in March 1865, was entitled to gloat in his annual report of that year, which "congratulate[d] Congress and the country on the popularity which the national banking system has achieved. . . . It is not among the least of the triumphs of the system," Clarke observed grandiloquently, "that, in a period of war, amid monetary disturbances, caused by the gigantic requirements of government, it has stood the test of practical experiment in the most satisfactory manner, vindicating the partialities of its friends, and overcoming by its beneficial effects the hostilities of its most determined enemies."

Safety and Soundness Triumphant

With competition from state banks largely eradicated, successive Comptrollers were able to advance Hugh McCulloch's vision of a national banking system in which safety and soundness reigned supreme. Hiland R. Hulburd, the fiscal Puritan who replaced Freeman Clarke as Comptroller in 1867, declared war on all manner of bank-related imprudence. Particularly odious to him was the practice of paying interest on deposits, a practice fueled by the growing competition among the big New York City banks for the correspondent accounts of their country counterparts. The problem, as Hulburd saw it, was that the city bankers then had to earn a return on those funds in whatever way they could, and, with a finite number of good loans available, more and more bad loans were being made. The New York banks, Comptroller Hulburd declared, "should not be allowed to jeopardize the funds of the country banks by loaning them for speculation and they would not, if they were not obliged to pay interest on them." His recommendation, endorsed by Secretary of the Treasury George Boutwell, was that Congress pass a law prohibiting bankers from doing so.

Failure to win Congress's assent to such a law did not discourage Comptroller Hulburd and his successor, John Jay Knox, from addressing other safety and soundness issues. Stiff prohibitions against real estate lending were already on the books. Section 14 of the National Currency Act of 1863 seemed to have simultaneously authorized and forbidden that practice. In the National Bank Act, Congress removed most of the ambiguity; with a few apparently minor exceptions, the law forbade national banks from lending against real property. This ban was grounded in pre-Civil War experience, which had seen banks sustain heavy losses in real estate speculation.

Congress's decision to keep national banks out of the mortgage business altogether was heartily endorsed by America's most prominent bankers. Let other intermediaries make real estate loans, wrote St. Louis banker Breckenridge Jones in 1897; the national banking system, the country's financial bedrock, must steer clear of such risky ventures. Claudius B. Patten, a Boston banker and author of the respected textbook *The Methods and Machinery of Practical Banking* (1891), saw "no immediate prospect of any modification of the [National] Bank Act in this respect, and it is well that such is the case."

Resurgent Competition

The view that real estate lending was a risky business, an opinion that was gospel in sound money circles, overlooked a basic business reality: national banks could afford to spurn opportunities for profit only as long as they were immune to competition from state-chartered institutions. However, by the late 1870s, state banks had begun to flourish once more. From a low of 277 in 1873, they increased tenfold by 1891 and then doubled again, to 5,600, by the turn of the century. National banks outnumbered state banks almost 4 to 1 as late as 1878; by 1892 that gap was completely erased. By 1893, state banks established a numerical edge that grew larger every year.

Two factors accounted for this rebound. The first was the waning effect of the 10 percent tax on state bank notes enacted in 1865. Bank notes, national and otherwise, were rapidly being supplanted by deposits in the nation's payment system. In 1870, deposits per capita amounted to some $20; that figure rose to $68 in 1900, by which time about three-quarters of the nation's business was being conducted by check.

This development hurt national banks. Not only was their once-prized monopoly on national bank notes eroding into irrelevance, but they were effectively shut out of the nation's burgeoning checking business because the National Bank Act and OCC regulations treated time and demand deposits alike for purposes of reserve requirements.

That was not all. National banks faced stringent limits on loans to individuals (the limits were higher or nonexistent in most states); prohibitions on stock ownership (state banks were generally free to own stock), and high capital minimums ($50,000 to $200,000, depending upon the size of the town) for establishing a new national

bank. By comparison, as late as 1895, at least 4 states had no minimum capital standard at all, while a host of others required $10,000 or less for a bank to incorporate.

State bankers also had more freedom to make real estate loans. At the turn of the century, only 12 states restricted mortgage lending, and the restrictions imposed by those states were generally either trivial or not enforced. In 1909, real estate loans constituted almost 12 per cent of state bank assets, compared to 0.6 per cent of the assets of national banks. Indeed, the 0.6 percent reflected both the loopholes in the National Bank Act as well as outright violations of that law.

Even more impressive inroads in the mortgage market were being made by nonbank lenders. According to one 1914 estimate, the roughly l2 per cent of state bank assets attributable to mortgages amounted to less than 2.5 per cent of all real estate lending in America. Most of those loans were placed by insurance companies, building and loan associations, mutual savings banks, and other private mortgage companies.

Although the risks associated with this lending were high — millions of dollars were wiped out in the farm depression of the early 1890s — so were the interest rates — as high as 10 per cent per annum — such loans carried. A 1914 study of New York-based mortgage companies showed average profits of around 15 percent, with returns in the 20 and even 30 per cent range not uncommon.

The examination requirement also placed national banks at a competitive disadvantage. Until the 1890s, most states imposed no examination requirement whatsoever. That was probably just as well, because examiners in those states that saw fit to employ them tended to be unqualified political appointees ignorant of banking law or practice. Still, some enlightened state bankers frankly regarded the absence of examination as too much benign neglect. Recognizing the potential commercial value of government inspection, they clamored for regular professional examination, and a few even converted to the national charter for the privilege.

Some who did so, however, came to regret it. Complaints from national bankers about their examiners were commonplace, the most chronic one being that inordinate haste in conducting the examination led to unwarranted demands for charge offs; personal knowledge of borrowers and other factors affecting individual loans tended to be discounted by examiners who seemed always to have one foot out the door on their way to the next bank.

The OCC Responds

If Comptroller Freeman Clarke's self-congratulatory complacency about the national banking system was warranted in the mid-1860s, it was as hopelessly outmoded 20 years later as some of the rules governing the system itself. Beginning with John Jay Knox (1872-84), Comptrollers of the Currency began to recognize and react to the challenges of the new competition, even if that meant edging away — however reluctantly — from their previous standards of safety and soundness. Between 1885 and 1891, in an effort to preserve the primacy of the national system, charter applications were approved almost without question, resulting in 1,000 new national banks, or one bank for every two already in operation.

Hard-pressed national bankers fought to protect their franchises. Some simply ignored restrictive laws, while others found legal loopholes to exploit. For example, by employing a variety of legal and extralegal stratagems, national banks, sometimes with the tacit approval of the OCC, managed to increase their participation in the booming mortgage market. According to a recent study, the actual level of real estate lending by national banks between 1885 and 1915 was far higher than the OCC's published statistics showed. Evasion and concealment accounted for some of the discrepancy. In 1911, Comptroller Lawrence Murray reported to Congress that as many as 16 per cent of all national banks held loans in violation of the real estate lending provision of the National Bank Act.

Another loophole permitted a national bank to take title to real estate in satisfaction of debt previously contracted. Banks and borrowers would agree to an unsecured loan with the understanding that real estate would be offered as collateral at a later date. Other banks, in a precursor to the modern bank holding company, would organize a mortgage and trust company under the same management and even the same roof as the bank.

While in no way endorsing outright violations of law, the OCC took an increasingly strong stand in favor of expanding the law's limits on real estate lending. Beginning in the late 1880s, Comptrollers urged Congress to amend the National Bank Act so as to allow national banks to do openly what the law was forcing them to do furtively in regard to real estate. In 1888, Comptroller William Trenholm pointed to "widespread feeling that the national bank law discriminates against real estate unjustly, and in agricultural communities this feeling is so strong that it is resentful and is made the ground of popular opposition to the whole national bank system."

Eventually this pleading by Comptrollers, added to that of would-be mortgage borrowers, had its effect. The Federal Reserve Act of 1913 authorized national banks to lend up to 50 per cent of the value of the land offered as collateral for a period not to exceed five years. Even these restrictions were relaxed over time, so that, at least as far as real estate lending was concerned, national banks were no longer at a critical competitive disadvantage against state-chartered institutions.

The Federal Reserve Act brought other long sought-after benefits to the national banking system. The act lowered reserve requirements for time deposits, enabling national banks to begin offering checking accounts on competitive terms. It granted national banks the right to provide trust services and to open foreign offices. The act also eliminated the fee structure of compensation for national bank examiners, which had rewarded haste and superficiality, and placed examiners on salary instead.

After strenuous lobbying by the OCC, Congress also eased the 10 per cent lending limit to individuals. Comptroller William Ridgely (1901-1908) and six Comptrollers before him had contended in their reports to Congress that the limit was too low and that the penalty for violations — revocation of charter — was Draconian. In an age when the typical business borrower operated out of a basement workshop, the loan limit was merely an occasional nuisance. But bigness was increasingly in vogue, and multimillion dollar banking transactions were not uncommon.

If, Comptroller Ridgely warned, banks could not accommodate loans of the desired size without breaking the law, the large industrial concerns would take their business elsewhere. His solution, adopted in 1905, was to allow national banks to count their undistributed profits as capital for purposes of the 10 per cent rule. Congress embodied this ruling into law the following year, with the caveat that total loans outstanding to any one individual could not exceed 30 per cent of the bank's primary capital.

Despite these supervisory improvements and new powers granted to national banks during the first two decades of the twentieth century, the 1920s, according to one scholar, remained years of "retrogression" for the national banking system. In both absolute numbers and market share, state banks extended the lead that had been building since the 1880s. In 1926, national banks commanded less than 50 per cent of the total assets held by [illegible] institutions. Hundreds of national banks [illegible] the system in favor of state charters during the decade.

Why? The Federal Reserve Act shattered the rustiest of the Civil War-era shackles on national bankers and provided a much-needed mechanism — access to the discount window — for propping them up in times of crisis. But these benefits came at a price — mandatory membership in the Federal Reserve System, with its idle reserve and stock-purchase requirements — that many bankers judged a bad bargain. Thus, defections mounted from the national banking system and state banks, which had the choice of joining the Fed or not, overwhelmingly voted to retain their independence. Nineteen twenty-two was the high water mark for state bank membership in the Federal Reserve System, with 1,648 state banks, a mere 8 per cent of the total, on the membership rolls.

Meanwhile, state banking authorities continued to grant large numbers of new charters and to press for continued liberalization of state banking laws. More than a dozen states also reduced their own reserve requirements in order to maintain their competitive edge over the national charter. Eight states had already established deposit insurance systems, which proved to be better confidence-builders than membership in the Federal Reserve System. By 1924, 10 states had done away with all branch banking restrictions — a particularly sore point for national banks, which had been clamoring for this privilege for years.

Once again, the national banks and the OCC sought to equalize competition. During the early 1920s, Comptrollers John Skelton Williams and Daniel R. Crissinger endeavored in their own chartering activities to keep pace with new state charters. And, like Comptrollers Trenholm, Ridgely, and others before them, they agitated for changes in the law to maintain the competitiveness of national banks. Congress responded by enacting the McFadden Act of 1927, providing national banks approximately the same power to branch as state banks. McFadden also broadened the range of securities national banks could hold, extended their charters in perpetuity (charters had previously run for 99 years), and allowed national banks to offer new services, such as safe deposit box rentals.

But the McFadden Act, though generally salutary in its intentions and effects, sharpened rather than resolved the questions about the future of national banking in the United States. What was the appropriate niche for national banks in the modern American financial world? How far were Comptrollers of the Currency (and Congress) willing to go to meet the competition of state banks and other financial intermediaries? What liberties were they willing to take with safety and soundness? Comptroller Crissinger (1921-23), who was more indulgent than most, finally found his own limits. After ap-

proving nearly every charter application that crossed his desk, he began to see applications of patently dubious character — for a second national bank in a Minnesota town with a population of 120, for example. Crissinger drew the line because such enterprises were doomed to fail. By the late 1920s, an agricultural depression and associated increase in farm bank failures provided an object lesson in the perils of over-banking. Comptrollers Joseph McIntosh (1924-28) and John Pole (1928-32) reacted accordingly, with Pole, for example, denying some 60 per cent of the charter applications that came before him in 1928.

The End of Competition?

The Great Depression swept away not only banks by the thousands but also the edifice of permissive law that had given rise to them. In its place arose a structure of law that controlled competition and reestablished a standard of safety and soundness that would have satisfied even the meticulous Hugh McCulloch. For banks that had survived the catastrophe, the Banking Acts of 1933 and 1935 pointed the way to a stable future. Although those two laws spared the dual banking system, the advent of federal deposit insurance and supervision by the Federal Deposit Insurance Corporation (FDIC) introduced an era of greater regulatory uniformity. Some bank powers, such as the authority to pay interest on demand deposits and to underwrite securities, were rolled back, and examiners enforced the law with a rigor unseen perhaps since the 1880s.

Chastened by this hard scrutiny and their own excesses, bankers during the 1930s curtailed lending to all but the most creditworthy clients. Although President Franklin D. Roosevelt and his economic advisers seized every opportunity to persuade bankers and examiners to ease credit, regulatory laxity and bank failure were now seen as cause and effect, ensuring that the administration's efforts in this area would remain rhetorical. Despite the president's efforts to encourage easier credit, bank lending in the 1930s never met expectations, a fact that contributed to the disappointing pace of economic recovery during the 1930s.

For the next 20 years, banks operated in the placid environment created by this New Deal legislation. The 1935 Banking Act had confirmed the OCC's discretionary authority to grant or deny charters on the bases of community need and prospects for success, as well as capital adequacy. Comptrollers J.F.T. O'Connor (1933-1938), Preston Delano (1938-1953) and Ray Gidney (1953-1961) vigorously exercised this authority. Between 1936 and 1955, only 211 national banks were chartered. State chartering authorities adopted similarly conservative policies. After World War II, at both state and federal levels, branching was embraced as a safer way to expand the availability of bank services to new suburban consumers.

OCC examiners making their twice-yearly visits to national banks during the 1950s generally found little to criticize. For that decade, capital in national banks averaged near 8 per cent, an impressive figure given the conservative assets — cash and government securities — that dominated bank portfolios. Returns on equity tended to be disappointing, but investments in bank stock were almost devoid of risk. From 1945 to 1960, only 5 national banks failed. Year after year, Comptrollers delivered the same summary assessment to Congress: the national banking system was in "excellent" health. Not even the wording changed.

Competition Returns

The stability — and stagnation — that characterized the national banking system from 1945 to 1960 was soon to end. Like the farsighted Comptrollers of the Currency of the past who had endeavored to wean self-satisfied national bankers — and their regulators — from the lethargy of a seemingly secure prosperity, Comptroller James J. Saxon (1961-66) warned that other intermediaries — savings and loan associations, credit unions, and state banks — were gaining on the national banking system with new powers and services.

"We are of the opinion," he wrote bluntly in his first annual report to Congress, "that the growth of our national banking system has not been up to potential, both in relation to size comparative to other financial institutions and with respect to its contributions to the economic growth of this nation."

Comptroller Saxon vowed to achieve a better balance between safety and soundness and competitiveness, through regulatory action where possible and through support for new legislation where the law impeded the ability of national banks to compete. A Saxon-organized study group of prominent national bankers produced a veritable catalogue of needed improvements, which the Comptroller proceeded to implement. He increased the legal lending limit and permitted banks to engage in a variety of businesses he deemed "incidental" to banking, including the sale of insurance and travel services. He authorized national banks to underwrite revenue bonds and to issue credit cards. He also chartered twice as many new banks in three years as his predecessors had chartered in the previous 10.

These actions made Saxon one of the most controversial officials in Washington. Lawsuits were brought against him by the insurance, brokerage, and data processing industries, charging that he had over-

stepped his authority in granting banks new powers. State bankers and their supervisors mounted an especially vigorous challenge. Almost 100 state banks converted to national charters during the Saxon years, sparking accusations that Saxon was an enemy of the dual banking system.

The lawsuits and challenges continued during the tenure of Saxon's successor, William B. Camp, a career bank examiner who served from 1966 to 1972. Although it had been Camp's intention to consolidate Saxon's gains, he found himself instead constantly on the defensive against the Department of Justice, which sought to block OCC-approved mergers, as well as state bankers and the nonbank providers of financial services. By 1973, when Comptroller Camp resigned due to ill health, many of Saxon's decisions, such as those on travel services, had been reversed in the courts.

But his most important contribution survived: the change in attitude in the banking industry. The complacency that Comptroller Saxon crusaded against was largely gone a decade later. In its place was a new spirit of entrepreneurship. Innovations such as the negotiable certificate of deposit and the development of the one-bank holding company took place. Cost-cutting initiatives and automation changed the way bankers operated. National banks expanded abroad in search of new opportunities.

Under Comptrollers James E. Smith (1973-76) and John G. Heimann (1977-1981), the OCC's opposition to the legal constraints that placed national banks at a competitive disadvantage continued. While nonbank competition in traditional areas of lending forced banks to seek profits elsewhere — as in the real estate investment trusts (REITS) of the early 1970s — inflation and stagnation throughout the decade eroded the value of bank loan portfolios and imperiled some institutions. A handful of spectacular bank failures in Comptroller Smith's term turned the debate back to safety and soundness issues. Meanwhile, Congress enacted a series of consumer laws that imposed new regulatory burdens on financial institutions.

Yet, by 1980 the pendulum was ready to swing back once more. A new era of deregulation began — an era full of turmoil for the nation's banks as well as for their principal regulator. Although the economic and political stakes were higher than ever before, the OCC's central mission remained unchanged. The quest begun in 1863 — for a national banking system that balances fuel for economic growth with reasonable risk to depositors, taxpayers, and shareholders — is a quest that continues today.

Jesse Stiller
Administration

Operations of National Banks, 1981-1991

Introduction

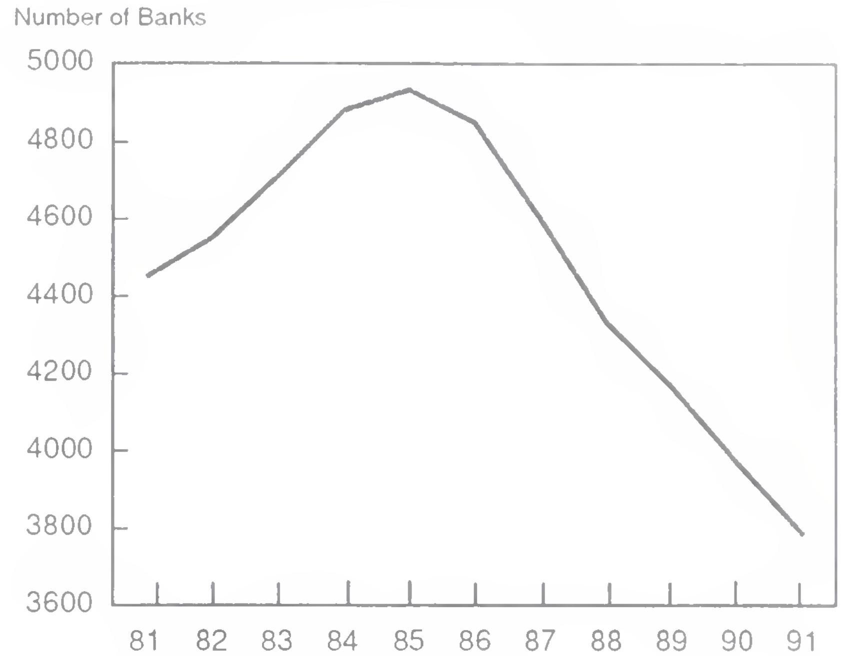
The 1980s were turbulent times for the national banking system. The stable environment of fixed interest-rate deposits, protection from nonbank competition, and solid earnings came to an end. Innovations in financial markets, advances in computer and telecommunications technology, and the relaxation of barriers to interstate banking fundamentally altered bank activities and the structure of the banking industry. Credit quality problems appeared in loans to borrowers in several different sectors of the domestic economy, especially in the agricultural, energy, and commercial real estate sectors. Those domestic loan problems, combined with the developing country debt crisis, weakened loan portfolios.

This article examines the changes in the national banking system from 1981 through 1991, referred to, for the sake of simplicity, as the decade of the 1980s. It analyzes changes to the structure of the banking industry caused by widespread consolidation of independent banking institutions and numerous bank failures. It reviews how national banks performed in a decade in which severe credit quality problems burdened earnings. Finally, the article examines new developments in the business of national banks, such as off-balance sheet activities. Although the article is largely limited to the national banking system, many of the issues discussed herein also affected all commercial banks.

Changes in the Structure of the National Banking System, 1981-1991

One of the most dramatic changes in the national banking system over the 1980s was apparent to a casual observer: many banks disappeared. At the end of 1981, the national banking system was composed of 4,450 national banks; by year-end 1991, that number had dropped 15 percent to 3,782.

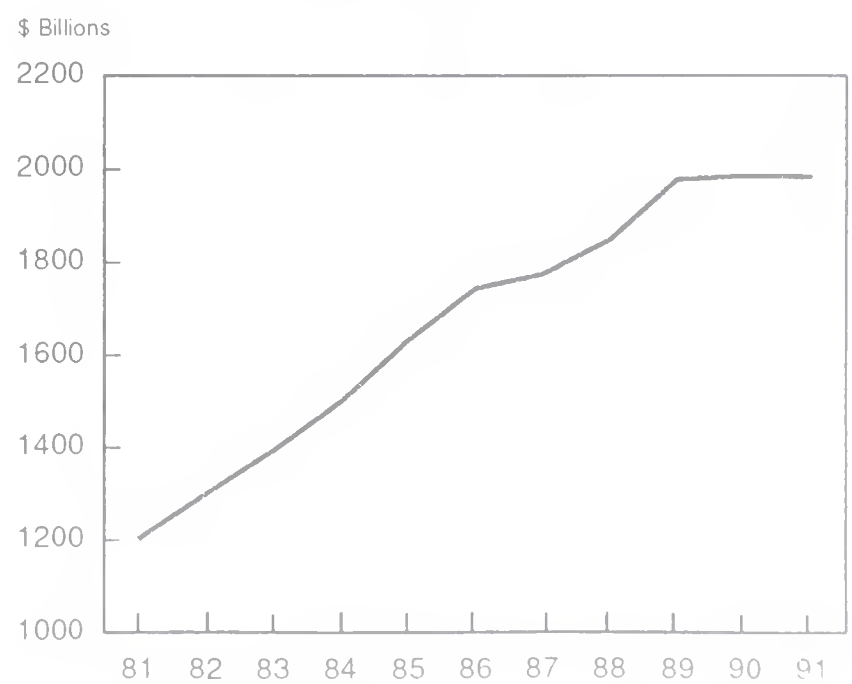
Number of National Banks



Source Call Reports

Other changes in the system were less apparent. The rate of growth in the system slowed. Even though the assets of all national banks increased 65 percent during this period — from $1.202 trillion to $1.981 trillion — this growth actually represents only a 17 percent increase in system assets, after accounting for inflation. Thus, the national banking system failed to grow as fast as the economy of the United States in the 1980s, which grew by 26 percent after inflation over the same period.

National Bank Assets



Source Call Reports

The decrease in the number of banks and the modest real asset growth of the system reflect the strain under which the national banking system — indeed, the whole banking system — operated during the decade. An unusually high number of banks failed. Significant numbers of mergers and acquisitions also took place, consolidating assets into fewer banks. The weak earnings of many of the surviving banks also dampened interest in new bank charters, slowing the entry of new banks into the system.

Failures

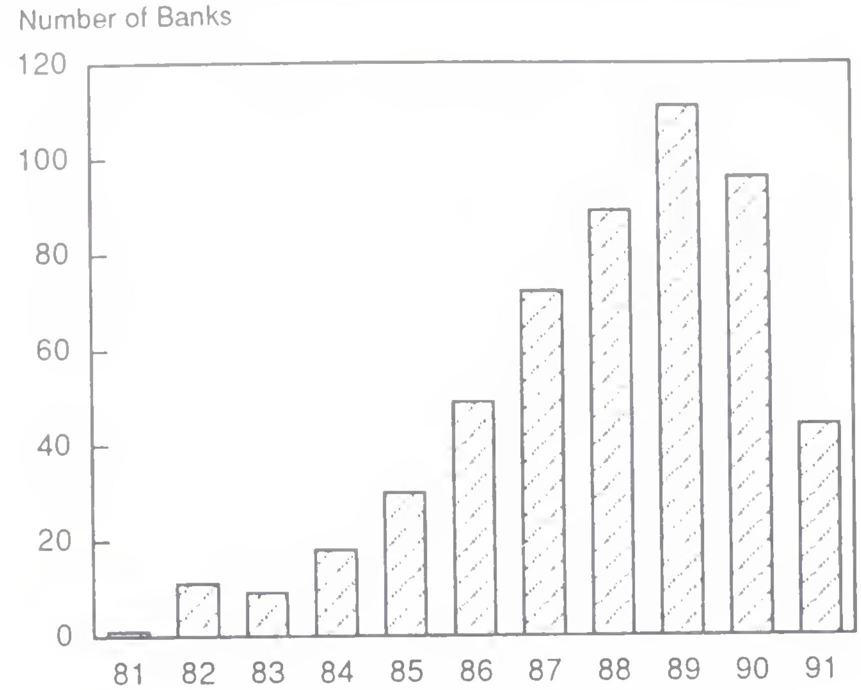
In contrast to the preceding four decades in which the commercial banking system remained relatively stable, the 1980s will long be remembered as a decade of instability in which an extraordinary number of banks failed. From 1934 to 1980, only 574 institutions insured by the Federal Deposit Insurance Corporation (FDIC) failed. During the next eleven years, 1981 to 1991, 1,372 banks insured by the FDIC or, starting in 1990, the FDIC's Bank Insurance Fund, failed. Failures included national banks, state-chartered banks, and savings banks. Some of the failures involved banks that were closed, resulting in the disappearance of the bank's charter and disposition by the FDIC of the bank's assets. Others were FDIC-assisted open-bank resolutions in which the bank remained open but management was replaced and stockholders generally experienced heavy losses.

Problems in the banking system were particularly severe, both in terms of the number of failures and the volume of assets in failed institutions, during the second half of the 1980s and the early 1990s. Rising from only 10 in 1981, failures peaked at 221 in 1988. Although the total number of failures dropped in 1989, 1990, and 1991, the assets of banks failing in 1991 surpassed the 1988 peak.

National bank failures from 1981 through 1991 roughly paralleled the experience of commercial and savings banks. Most of the 530 national banks failing in this period occurred in the second half of the decade: only one national bank failed in 1981, while 111 failed in 1989. After this peak, failures fell to 44 in 1991. Assets of failed national banks reached high points in 1988 and 1991, with $44.5 billion and $36.8 billion respectively.

National bank failures from 1981 through 1991 were geographically concentrated. At 382, the Office of the Comptroller of the Currency's (OCC) Southwestern District experienced the vast majority of these failures. [illegible] why so many failures took place [illegible] because Texas did not permit branch [illegible] large number of national [illegible] in 1986, for example,

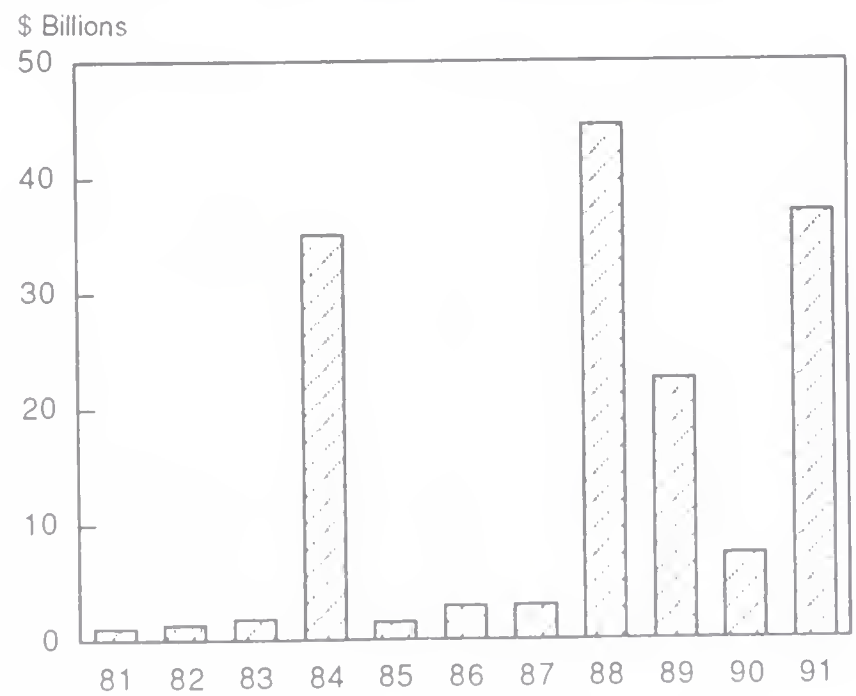
Number of National Bank Failures/Resolutions



Source: FDIC Annual Reports, FDIC Failed Bank Cost Analysis

there were 1,077 national banks in Texas, or 22 percent of all national banks in the country in that year. Many of these banks were poorly prepared to withstand the severe economic decline that occurred first in the energy and then in the real estate sectors in the Southwest. During the entire period, therefore, the Southwestern District had, on average, 27 percent of all national banks in the country but 72 percent of all failures. The rest of the failures were spread somewhat evenly across OCC's five other districts.

Assets of Failed/Resolved National Banks



Source: FDIC Annual Reports, FDIC Failed Bank Cost Analysis

The assets of failed institutions were slightly less geographically concentrated. The Southwestern District accounted for just over half, $79 billion, of the total assets of failed national banks between 1981 and 1991. The Central District had 22 percent of total assets in failed national banks and the Northeastern District ac-

counted for 18 percent. In the Southwestern District, a large number of the failures were very small banks. Conversely, while relatively few failures took place in the Central and Northeastern districts, those that failed or received FDIC assistance included large banks such as Continental Illinois Bank and the Bank of New England.

From 1981 through 1991, 32 percent of all FDIC-insured institutions, on average, were national banks and 39 percent of the institutions that failed were national banks. Over the same period, national banks held, on average, approximately 56 percent of the FDIC-insured bank assets. Although failed national banks held approximately 62 percent of the assets of all banks that failed, according to the FDIC national bank failures accounted for 53 percent of the estimated losses borne by the FDIC from 1985 through 1991 — the years for which FDIC loss estimates are available.

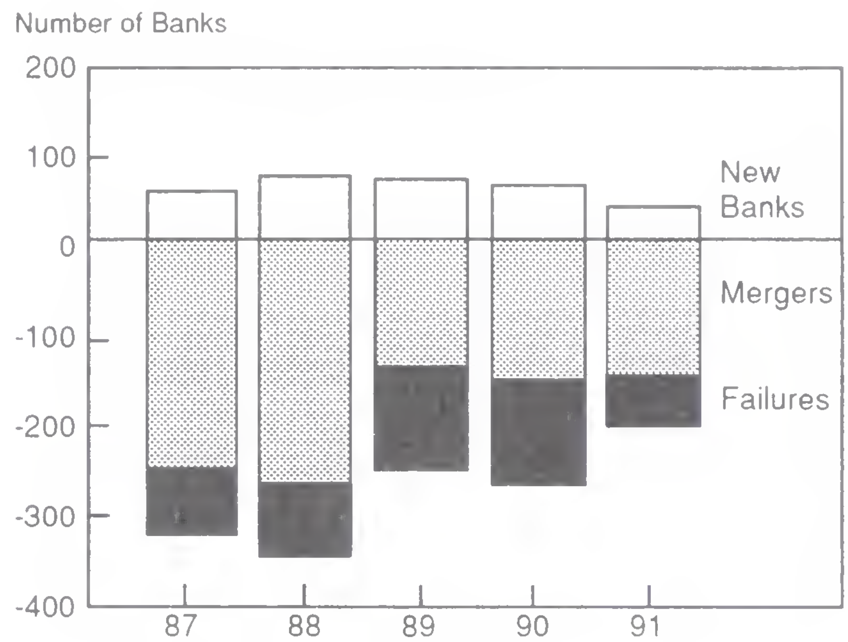
Industry Consolidation

Industry consolidation also altered the structure of the national banking system during the years 1981-1991. Since acquisitions, mergers, and reorganizations often involved banks with different charter types, the effect of consolidation of the national banking system is best understood as part of the consolidation of the entire commercial banking industry.

During the last decade, commercial banking assets increasingly became concentrated in large banks and multibank holding companies, many of them operating in two or more states. From 1981 through 1991, the number of FDIC-insured commercial banks operating in the United States and its territories declined about 20 percent — from nearly 14,500 to under 12,000, while the number of separately owned banking companies dropped about 25 percent — from over 12,000 to fewer than 9,500. Over that same period, the share of total commercial bank assets held by banks with $1 billion or more in assets rose from 62 percent to 70 percent, and the share of total bank assets held by multibank holding companies increased from about one-third to over three-fourths. The number of companies operating banks in more than one state increased more than tenfold between 1981 and 1991, to around 160.

These organizational changes in the banking industry had their greatest impact on national banks after the middle years of the decade. Although the number of national banks actually increased each year between 1981 and 1985, it declined each year from 1986 through 1991. Holding company consolidation of existing operations was the primary reason for the decline in numbers of national banks. Consolidation was especially noteworthy in states such as Texas and Illinois which did not ease long-standing branching restrictions until the latter years of the decade. Diminished chartering activity and conversions to state charters contributed to a lesser extent. Merger activity led to the disappearance of nearly 1,000 national bank charters between 1986 and 1991. Over that same period, the share of total national bank assets held by banks with $1 billion or more in assets rose from 72 percent to 79 percent.

Change in Number of National Banks



Source Federal Reserve Board Structure File

Although consolidation diminished the number of national banks during the decade, the importance of the national banking system did not diminish because consolidation occurred throughout the banking industry. While the number of national banks fell 15 percent over the decade, the share of commercial banks with national charters rose slightly — from 30.1 percent to 32.1 percent — and the share of total commercial bank assets held by national banks remained unchanged at around 59 percent. Nor did consolidation eliminate small banks from the national banking system. At the end of 1991, half of all national banks had assets below $67 million.

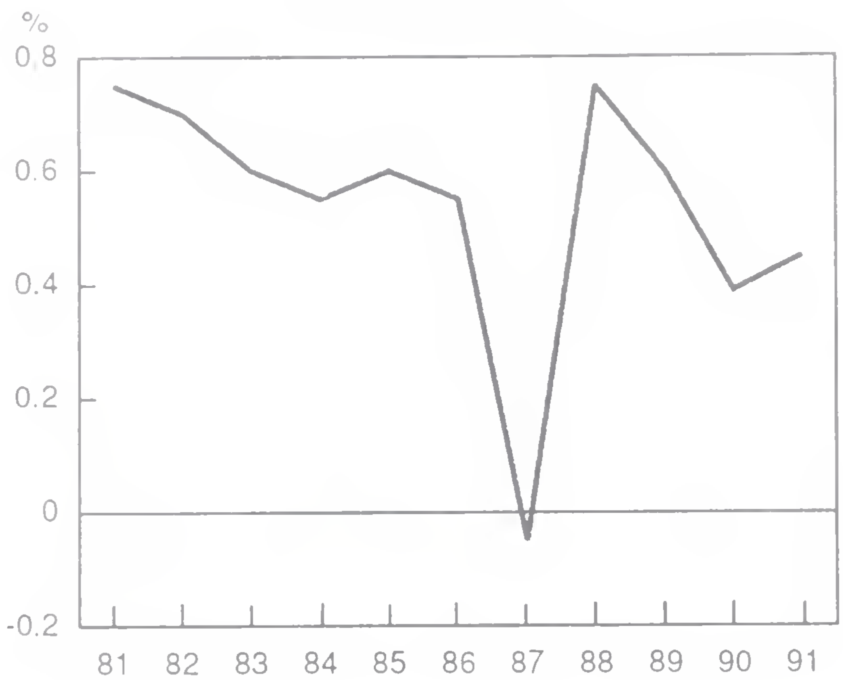
Changes in the Performance of National Banks

The aggregate performance of national banks reflects the problems that contributed to bank failures, sluggish growth, and the restructuring in the industry from 1981 to 1991. Although the vast majority of national banks were profitable throughout the decade, aggregate earnings declined and a sizable minority of banks incurred losses. The weak earnings experienced by banks throughout the decade were a reflection of a general deterioration in the credit quality of loans

Profitability

Even though the majority of national banks were profitable throughout the decade, profitability was weak. The national banking system's aggregate return on assets (ROA) — aggregate net income divided by aggregate average assets — was 0.46 percent in 1991 compared with 0.71 percent in 1981. Aggregate return on equity (ROE) began the period at 13.03 percent in 1981, fell to -0.28 percent in 1987 and remained below historical levels, ending the period at 7.32 percent.

Return on Assets



Source: Call Reports

Return on Equity

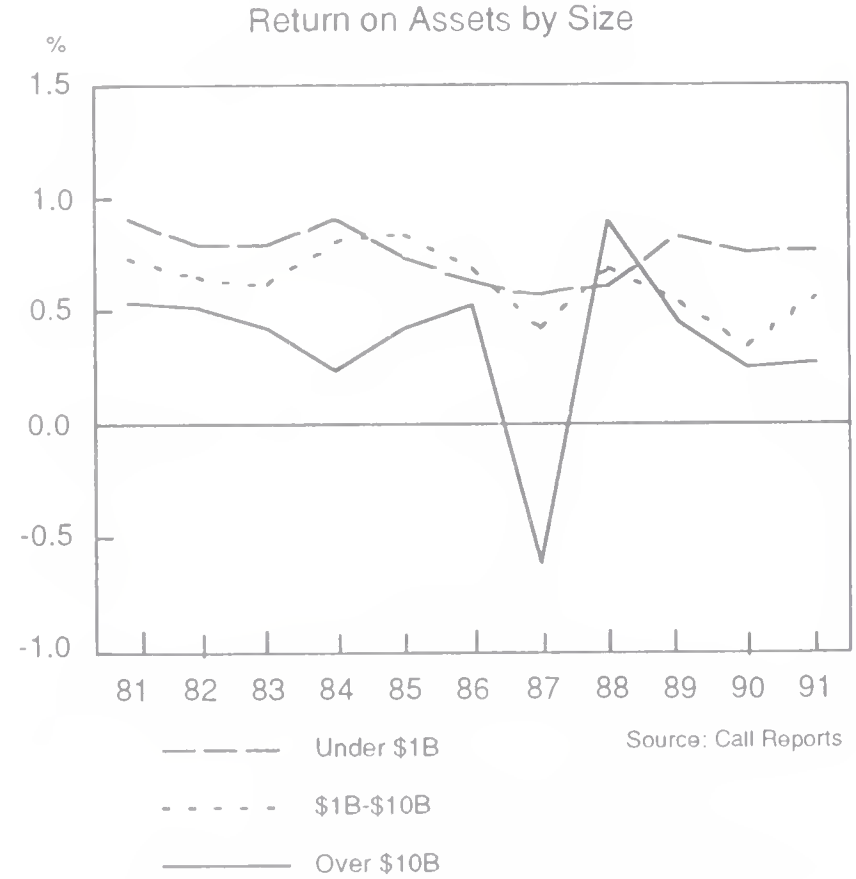
Source: Call Reports

During the decade an increasing number of national banks lost money. In 1981, five percent of national banks lost money. That share grew through 1986, when [illegible] national banks reported losses. By the end of the period, the share of national banks reporting losses had fallen, but nevertheless remained high at 13 percent.

These aggregate performance measures mask the performance of most banks because the numbers are dominated by the largest banks. For example, in 1991, while aggregate ROA was 0.46 percent, half of all national banks had earnings over 0.92 percent of assets and 10 percent of national banks had earnings greater than 1.5 percent of assets. This happened because, throughout the decade, the largest national banks tended to be less profitable than other banks.

The profitability of the largest national banks was also more volatile over the decade than that of their smaller counterparts. Banks with more than $10 billion in assets lost $4.7 billion in 1987, followed by a record $7.3 billion in earnings in 1988. Those banks ended the period with earnings that were below the level of the early 1980s.

Return on Assets by Size



Source: Call Reports

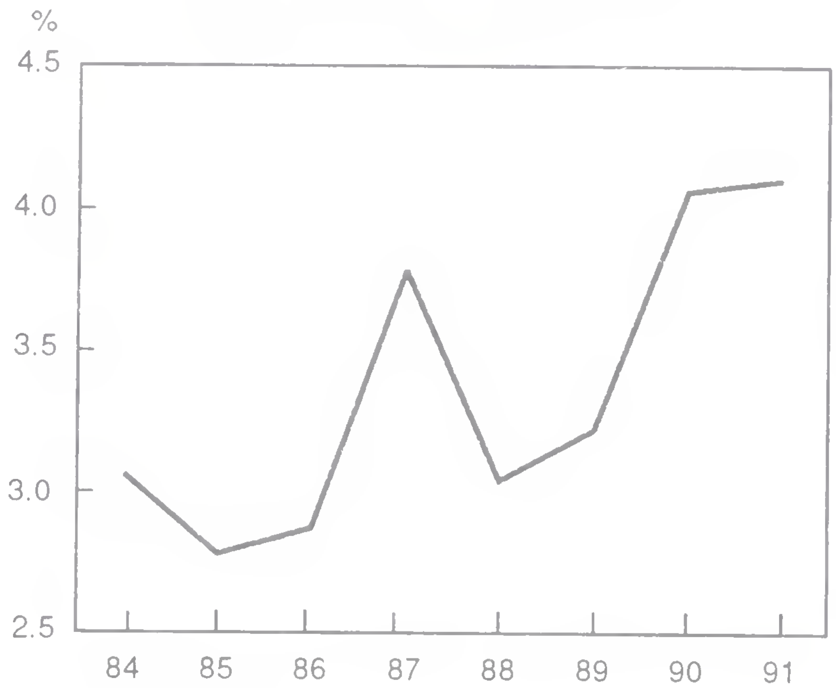
Credit Quality Problems in the 1980s

The dramatic increase in credit quality problems was the underlying reason for the decline in bank performance in the 1980s. Unlike savings and loan institutions that were beset, at least initially, by declines in net worth caused by adverse movements in interest rates, commercial bank problems centered on declining credit quality.

The deterioration in credit quality in the national banking system is best demonstrated by the rise in the ratio of noncurrent loans to total loans. (Noncurrent loans are

loans that are 90 days or more past due or are no longer accruing interest revenues for the bank.) From 1984, the first year of a consistent data series, to 1991 the ratio of noncurrent loans to total loans rose from 3.06 percent to 4.10 percent. While the level of noncurrent loans actually fell slightly between 1990 and 1991, the noncurrent ratio rose somewhat due to a faster decrease in the volume of loans outstanding.

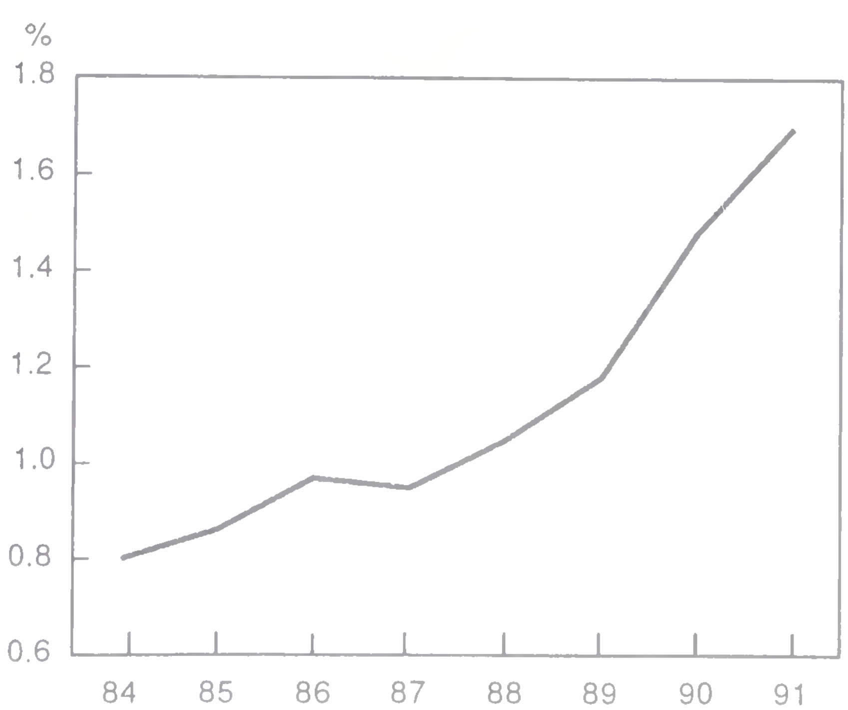
Noncurrent Loans to Total Loans



Source: Call Reports

The increase in noncurrent loans over the decade led to more than a doubling of the loss rate on loans for all national banks. Net losses as a percent of loans increased from .8 percent in 1984 to 1.7 percent in 1991. The loss rate increased across all three major categories of loans — commercial and industrial, real estate, and consumer loans.

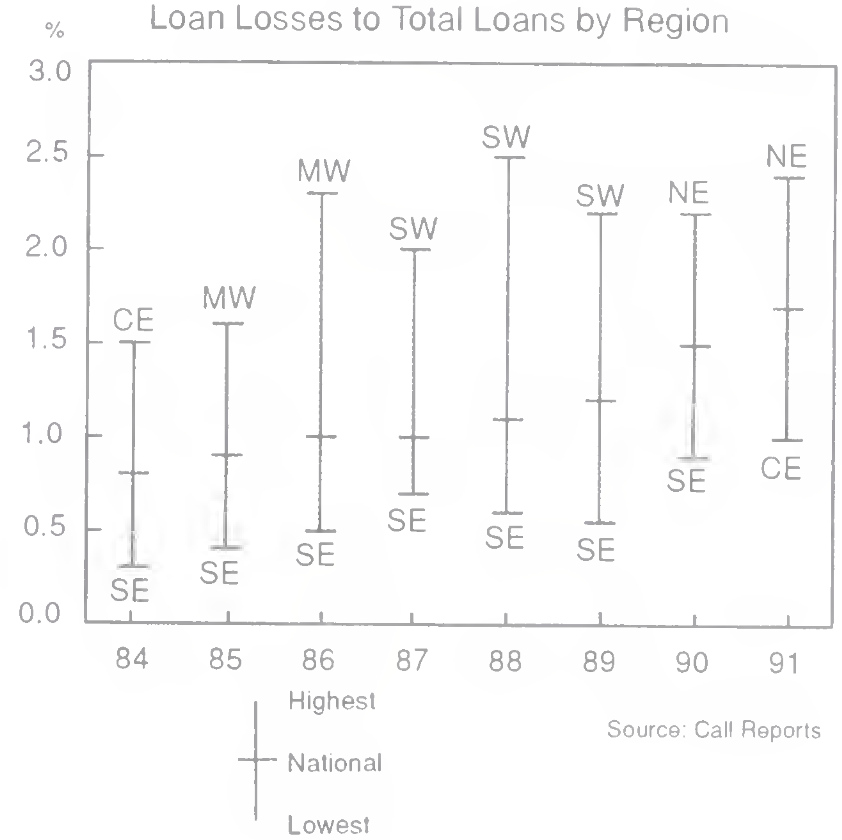
Loan Losses to Loans



Source: Call Reports

While the aggregate loan loss rate increased relatively steadily over the decade, the pattern differed among national banks in OCC's districts. In 1984, the Southeastern District had the lowest ratio of loan losses to loans, .33 percent, and the Central District had the highest ratio of loan losses to loans, 1.44 percent. Although the Southeastern District experienced an increasing loss rate over the years, it nevertheless maintained the lowest rate among the districts through 1990. By 1991, the loan loss rate of most regions rose significantly, except for the Central District, where it fell to 1.04 percent, making this the lowest rate among the districts. In contrast, between 1981 and 1991, the Northeastern District moved from having the second lowest loan loss rate (at .39 percent), to the highest, 2.38 percent.

Loan Losses to Total Loans by Region



Source: Call Reports

Sector and Regional Shocks

Over the course of the decade, problems in four categories of loans — agriculture, oil and gas, commercial real estate, and developing countries — were the principal sources of systemic problems in the banking industry. Some geographic regions of the country were hit by more than one type of problem loan; in those cases disruptions were felt over long and overlapping time periods. Moreover, some big banks that held large exposures to the debt of developing countries were also exposed to other weakened sectors or regions, such as the commercial real estate market in the Southwest and Northeast.

Agriculture

Agriculture was one of the sectors of the U.S. economy to experience a boom-and-bust cycle in the 1980s.

Export markets for agricultural products grew rapidly during the 1970s leading many farmers to borrow from banks in order to expand their operations and acreage. Much of the debt was collateralized by farm land, which was appreciating in value rapidly due to increased demand. The boom ended in the early 1980s when farm export markets weakened significantly, leading to sharp drops in commodity prices and agricultural land prices. Consequently, many farmers who had taken on heavy debt burdens were no longer able to service their debt. Banks could not recover loan principal because many borrowers were unable to repay their loans, and the land, pledged as collateral for the loan, had fallen to a value below the outstanding debt obligations of the borrowers.

Banks located in a relatively few states suffered the most from this agricultural downturn. Agricultural banks, banks with ratios of agricultural loans to gross loans greater than the national average, were heavily concentrated in the 11 states in the middle of the country, including the seven states of the OCC's Midwestern District. In 1981, 2 percent of all agricultural banks lost money. By 1986, the share of agricultural banks losing money rose to 19 percent. National banks in the OCC's Midwestern District had the highest loan-loss ratio of all OCC districts in 1985 and 1986.

Those losses contributed to bank failures. After one agricultural bank failed in 1981, the number of failures rose fairly steadily through the middle years of the decade, reaching at least 65 a year in 1985, 1986, and 1987. Failures of agricultural banks as a share of all commercial bank failures peaked at 58 percent in 1985, declining thereafter as other sectors of the economy in other regions of the country began to surpass agriculture as a source of problem for banks. By 1987, failures of agricultural banks accounted for only one-third of commercial bank failures. The number of agricultural bank closures fell steadily through the rest of the period and in 1991 only eight agricultural banks failed.

Energy

Shortly after the beginning of the agricultural cycle, a boom-bust cycle in the energy sector also occurred. After the Arab oil embargoes and the Iranian revolution in 1979 crude oil prices rose from $12 a barrel to a peak of $35 a barrel in 1980. During the early 1980s, companies in the energy sector responded to these dramatic price increases by borrowing from banks to increase oil and gas exploration and production capacity. When oil prices fell, borrowers could not generate enough revenue to repay loans.

Banks in the Southwest were particularly hard hit, after [illegible] the [illegible] with the highest aggregate ROA in the country [illegible] slumped for most of the rest of the decade. National banks in the Southwestern District experienced the highest loan loss rates in the country from 1987 through 1989 and, in the aggregate, lost money from 1986 through 1989.

Commercial Real Estate

While loans to energy-related companies played an important role in the woes of Southwestern banks, they were not the sole source of loan losses. The collapse of the energy sector weakened the entire regional economy, leading to a regional recession that hit the commercial real estate sector particularly hard.

Moreover, the commercial real estate sector also began experiencing problems in other regions of the country. By the end of the decade, commercial real estate markets across the U.S. were suffering the most severe slump since before World War II. Excess supply and stagnant or falling values were found in diverse property types and in diverse geographic locations. Although markets across the country slumped at different times, virtually all of the large metropolitan areas in the country were affected.

Office markets experienced the most severe problems. Office space was built faster than it could be absorbed, leading to increasing vacancies and falling rents and prices in most cities. With rents below anticipated levels, many builders were unable to sell new properties at anticipated prices, keeping them from repaying the principal on development loans. In addition, many owners of existing commercial properties were unable to meet mortgage payments as their tenants were enticed away or their rents were bid down as a result of cheaper rents on other properties.

Commercial real estate problems were concentrated first in the Southwest, the region hit hardest by the energy crisis. According to CB Commercial/Torto Wheaton Research, office vacancy rates in Dallas, Texas, rose from 6 percent in 1980 to 28 percent in 1987. Houston experienced an even greater deterioration in its office market, with vacant office space increasing from 6 percent of office space in 1982 to nearly 32 percent in 1988.

National banks in the Southwest played a large role in the financing of the region's commercial real estate development that took place in response to the energy boom. Real estate lending by national banks in the Southwestern District grew by more than 25 percent a year in 1982, 1983, and 1984. Real estate lending that directly financed construction grew by over 33 percent in each of those years.

The credit quality of the real estate loan portfolios of the surviving national banks in the Southwest improved by

the end of the decade. The ratio of noncurrent real estate loans to total real estate loans fell to 3.6 percent by the end of 1991. For the largest banks, the improvement was even greater, with the rate of noncurrent loans falling to 1.3 percent by the end of 1991. However, some of the improvement was due to the recognition of losses, and the failure of many highly exposed institutions.

Late in the 1980s, the Northeast, especially New England, experienced similar downturns in commercial real estate markets. For example, office vacancy rates in Boston, Massachusetts, rose from 7 percent in 1984 to 18 percent in 1990. As was the case in the Southwestern District, national banks in the Northeastern District played a large role in the financing of the commercial real estate development. Real estate lending by national banks in the Northeastern District grew by between 20 and 38 percent each year from 1984 through 1988; construction lending grew by 34 percent in 1984, by 38 percent in 1985, and by 43 percent in 1986.

The effect on banks was similar to that in the Southwest. Between 1988 and 1990, the ratio of noncurrent real estate loans to total real estate loans held by national banks in the Northeastern District rose from 2.0 to 9.2 percent. Once again, the largest national banks, those with over $10 billion in assets, were hit even harder, experiencing an increase in their noncurrent real estate loan rate from 2.7 percent in 1988 to 11.5 percent in 1990.

By the end of the decade, the problems in commercial real estate had spread to cities throughout the country. For 31 large metropolitan markets, CB Commercial/Torto Wheaton reports that the aggregate vacancy rate hovered at nearly 19 percent in 1991, the highest rate recorded in the 25 years for which data are available. As had occurred in the Southwest and Northeast, high vacancy rates and other problems led to an increase in noncurrent real estate loans in national banks in other parts of the country. In 1991, 5.4 percent of all real estate loans held by national banks were noncurrent, the highest rate since at least 1984.

While the rate of noncurrent real estate loans continued to be highest in the Northeastern District, national banks in the Western District also began to experience problems with their real estate loan portfolios in 1991. Noncurrent real estate loans in national banks in the West grew from 2.4 percent of all real estate loans in 1990 to 4.6 percent in 1991.

Developing Countries

Domestic borrowers were not alone in having difficulty repaying their debts in the 1980s. The developing nations, which had increased their bank borrowing beginning in the second half of the 1970s, began experiencing problems in the early 1980s. By 1983, aggregate commercial bank loan exposure to the developing countries was around $100 billion, loans to four Latin American countries constituted most of that debt. While that represented a relatively small exposure for the U.S. banking system — 8 percent of total loans outstanding in 1983 — it was heavily concentrated in a small number of banks. Twenty of the biggest commercial banks held over 80 percent of total bank loans to those countries.

The developing economies did not grow enough to provide the resources necessary to service their debt, and many countries stopped repaying their bank loans, beginning with Mexico in 1982. In 1987, in recognition of the seriousness of the problem, banks with large exposures to developing country loans made large provisions to their allowances for loan losses. National banks with over $10 billion in assets, which included the banks most exposed to the developing countries, made provisions of $15.9 billion in 1987. That was over two and one-half times the average level of provisions made by those banks in the other years between 1981 and 1991. Naturally, this high rate of provisioning severely depressed the earnings of the largest banks. In 1987, while the other size classes experienced mild decreases in earnings, national banks with more than $10 billion in assets lost $4.8 billion, for an overall ROE of a –12.5 percent.

After building reserves against loans to developing counties in 1987, the large banks shrank their portfolios over the rest of the decade. Between 1986 and the third quarter of 1991, the volume of commercial bank loans to developing countries fell nearly 60 percent. The distribution of the remaining debt, however, became even more concentrated. By the third quarter of 1991, 10 commercial banks held nearly 90 percent of commercial bank exposure to the developing countries.

Changes in the Business of National Banks

The decade of the 1980s also brought fundamental changes in the way banks do business. Faced with the increasing reliance of their commercial and industrial loan customers on the commercial paper market, which permitted larger businesses to obtain funding at lower costs than bank loans, commercial banks began to pursue other types of borrowers. In 1988, real estate lending replaced commercial and industrial lending as the largest category of national bank lending. In addition, securities holdings, such as mortgage-backed securities, became one of the few areas of continuous growth for national banks. On the liability side, the removal of deposit rate ceilings and the development

of new interest-bearing deposits fundamentally changed commercial bank funding. Finally, national banks participated in the development and use of new markets and activities that dramatically increased their involvement in lines of business that are not reported on the balance sheet.

Asset Composition of National Banks
(in percentages)

Assets	1981	1991
Loans	55.7	61.9
Securities	10.6	18.2
Other assets	33.7	19.9

Loans

The origination and holding of loans has always been the primary business of banking. This did not change in the 1980s. Loans made up 55.7 percent of total national bank assets in 1981 and rose to 61.9 percent of assets in 1991. This growth represents nearly a doubling in the dollar volume of the loan portfolios of banks: from $669 billion in 1981 to $1.228 trillion in 1991. However, the general growth in the volume of loans held by national banks masks some important changes in the trend of loan growth and in the composition of national banks' loan portfolios.

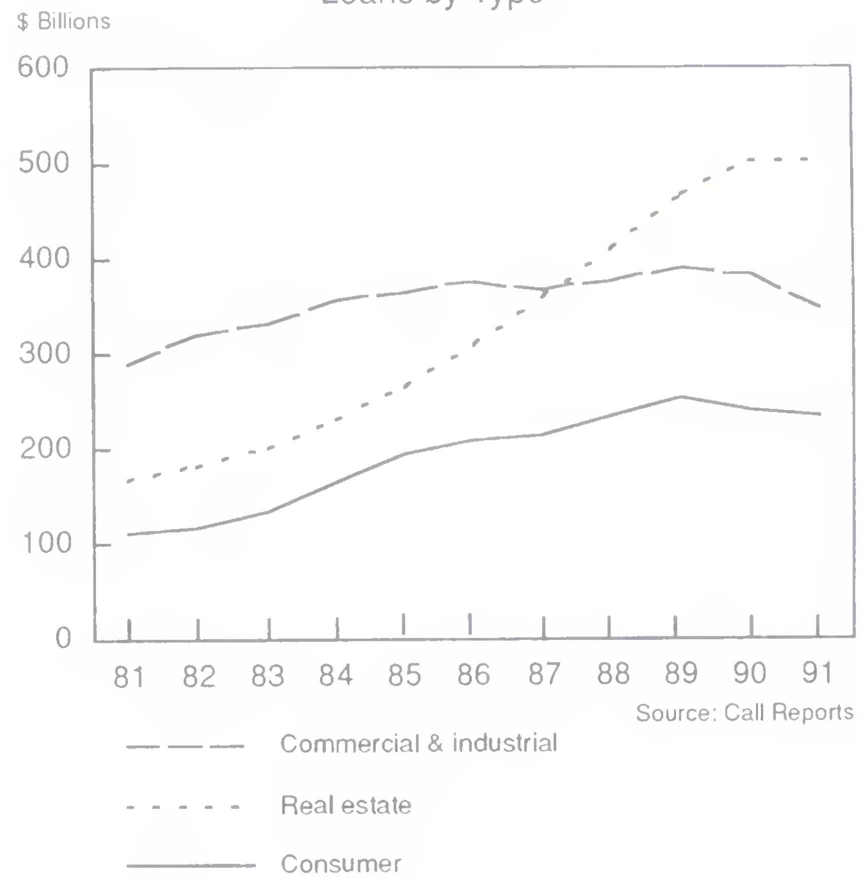
In the early 1980s, loan volume at national banks grew dramatically. The growth occurred in all size classes of banks and in all regions. Starting in 1986, some regions of the country began to show one or two years in a row of declining loan volume. Most dramatic was the decline in the loan volume at national banks in the Southwestern District; the region's energy and real estate problems and the failure of some large national banks led to a decline in the aggregate loan portfolios of national banks in every year from 1986 through 1991.

The rapid loan growth of the 1980s did not continue in the early 1990s. In 1990, the volume of loans barely grew and in 1991 it fell by 3.8 percent. This slowing of the growth of loan portfolios is true for national banks in all size classes and in all regions of the country. For the Southeastern, Central, and Midwestern districts, 1991 was the first year of the period in which loan volume declined.

Real Estate Loans

During the 1980s, national banks reversed the roles of [illegible] and commercial and industrial lending. The volume of real estate loans [illegible] residential, [illegible] in the national banking system [illegible] rising from $168 billion in 1981 to $502 billion in 1991. In 1981, real estate loans represented 25.1 percent of all national bank loans while commercial and industrial loans, at 43.0 percent of all loans, were the largest loan category for national banks, having an outstanding loan volume of $288 billion. By 1991, commercial and industrial loans accounted for only 28.3 percent of national bank lending ($348 billion), while real estate lending represented 40.9 percent.

Loans by Type

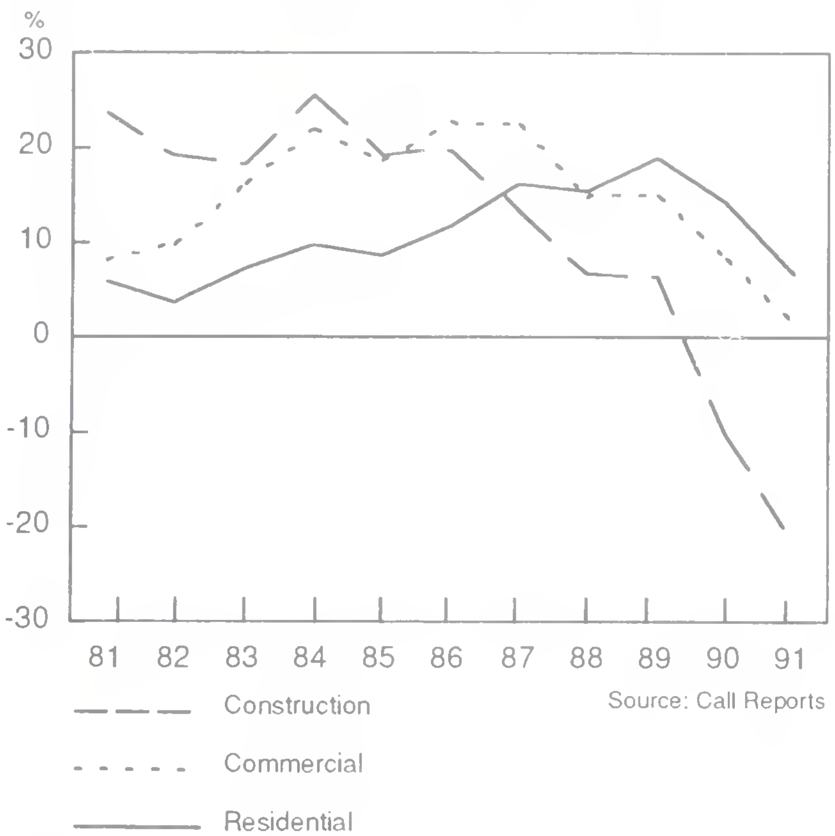


During the decade, national banks also experienced substantial shifts within their real estate portfolios. Holdings of one-to-four family residential mortgages, the largest single category of real estate lending, increased by 183 percent over the period. By 1990 and 1991, residential mortgage lending was the major area of growth in bank lending and it was increasingly important as a source of continued growth for the national banking system. In 1990, residential lending grew by $31 billion or 14 percent. Although this lending slowed in 1991, it nevertheless grew by $16 billion, or 6 percent.

Despite the growth, residential real estate lending fell slightly as a proportion of the total real estate portfolio of national banks because the growth was overshadowed by a 300 percent growth of commercial real estate lending. In 1981, one-to-four family loans accounted for 53 percent, or $90 billion of real estate portfolios, compared with 50 percent, or $252 billion in 1991. In contrast, commercial real estate loans accounted for 21.4 percent of real estate loans outstanding at the end of 1981, or $36 billion. By the end of 1991, commercial real estate represented 28.7 percent of real estate lending, or $144 billion. Construction and land

development loans also increased during the early part of this period, rising from 16.7 percent of real estate lending in 1981 to a peak of 22.4 percent in 1986 before receding to 12.3 percent by 1991.

Annual Growth Rate of Real Estate Loans by Type



Source: Call Reports

Securities

Securities holdings of national banks grew by nearly 183 percent from 1981 to 1991, a growth rate much higher than that of loans. This increase was largely made possible by the development and growth of the mortgage-backed securities (MBSs) market. National bank holdings of Treasury securities grew by 100 percent over the decade — slightly more than the aggregate growth of loans. Non-Treasury securities, which are primarily MBSs issued by the Federal National Mortgage Association (Fannie Mae), the Government National Mortgage Association (GNMA), and the Federal Home Loan Mortgage Corporation (Freddie Mac), grew by over 200 percent during this period. At year-end 1991, those mortgage-backed securities totalled $138 billion, or 40 percent, of all securities held by national banks. MBSs, which barely existed at the beginning of the decade, accounted for much of the growth in bank securities holdings during this period.

Liabilities

The funding of assets by national banks fundamentally changed during the years 1981-1991. When deposit rate ceilings were phased out at the beginning of the decade in favor of deregulated interest rates, product innovations presented new opportunities and challenges for all commercial banks. New retail deposit products such as money market deposit accounts and interest-bearing transaction accounts were developed, largely replacing noninterest-bearing transaction accounts and low-rate passbook accounts. These new products provided banks with greater flexibility in their methods of attracting deposits and thereby enabled banks to maintain their deposit base: deposits grew by 70 percent from 1981 to 1991, slightly more than the 65 percent growth in assets.

Off-Balance Sheet Activities

Perhaps the most remarkable change in the activities of national banks over the past decade has been the growth in activities that are not reported as assets on the balance sheets of banks. These off-balance sheet activities grew as banks responded to technology and market innovations. Technical progress in information processing, telecommunications, and financial modeling opened new lines of businesses for banks as well as providing an opportunity for them to offer services to customers that were previously unavailable.

Of course, banks have traditionally engaged in some service activities that are not directly reflected in their on-balance sheet portfolio investment activities. Loan commitments and letters of credit are examples of off-balance sheet activities that have long been, and continue to be, important parts of the basic business of banking. However, the role played by banks in offering those services changed during this period. For example, as former bank borrowers increasingly gained direct access to the commercial paper market, banks began to provide lines of credit that served as backup sources of liquidity for customers that issue commercial paper.

Credit card commitments and home equity commitments, two other types of previously existing off-balance sheet activities, grew in importance during the last decade. Data on those commitments have only been available for two years; the numbers show that credit card commitments had risen to $273 billion and home equity loan commitments had grown to $36 billion by year-end 1991.

The most striking examples of the increased reliance by banks on off-balance sheet activities involve products that barely existed at the beginning of the decade. Those new activities include buying and selling forward and futures contracts on currencies, interest rate swap contracts, and purchasing or writing interest rate option contracts. These activities are often called derivative product activities because they depend on some underlying contract or commodity for their existence. They tend to be relatively sophisticated and complicated transactions — requiring sophisticated modeling and careful monitoring in order to ade-

quately control risks. Because of these demands, the banks that are heavily engaged in the activities tend to be the biggest banks and since many of those are national banks, the amount of this activity in the national banking system has grown dramatically.

The biggest single type of activity, in terms of the underlying magnitudes on which the contracts are written, is forward and futures contracts. A futures or forward contract commits the bank to purchase or sell a specific financial instrument on a specific future date at a specified price or yield. Futures contracts are standardized, transferable agreements traded on organized exchanges where the exchange acts as the counterparty to each contract. Forward contracts are not standardized and are not traded on organized exchanges.

Futures and Forward Contracts of National Banks,
December 31, 1991
(par value of outstanding contracts)
(dollar amounts in billions)

	All national banks	25 largest national banks
Foreign exchange contracts	$1,553.2	$1,539.4
Interest rate contracts	634.8	580.1
Commodities and equities contracts	14.5	12.9

National banks reported a par value of all forward and futures contracts, including foreign exchange, interest rate, and commodity contracts, of over $2 trillion in 1991, up nearly 500 percent from the $383 billion reported in 1984, the first year for which those data were reported. Over two-thirds of the 1991 total represented foreign exchange forward and futures contracts. The remaining amount consisted of interest rate and other forward and futures contracts, products of more recent origin first reported by banks on Consolidated Reports of Condition and Income (call reports) in 1990. The 25 largest national banks held 97 percent of all forward and futures contracts reported by national banks in 1991.

Swap contracts grew even faster than forward and futures contracts. A swap contract is an agreement to exchange a stream of income or expense based upon the principal amount of the contract. For example, a bank may agree to pay its customer a fixed rate of interest on a notional contract of $1 billion in return for interest payments on the $1 billion contract that vary with changes in some independent measure of interest rates. Swap contracts are commonly reported by the notional value of the underlying principal amounts of the outstanding contracts even though the actual notional amount is never exchanged between the counterparties and, thus, does not represent the actual risk exposure of the bank.

National banks reported a notional value of swap contracts over $1 trillion in 1991, up more than 500 percent from 1986, the first year in which those contracts were reported. Nearly 90 percent of the 1991 total consisted of interest rate swap contracts. The 25 largest national banks reported nearly 90 percent of the national bank 1991 total.

Holdings of National Banks of Swap Contracts,
December 31, 1991
(notional value of outstanding contracts)
(dollar amounts in billions)

	All national banks	25 largest national banks
Interest rate swaps	$947.6	$842.1
Foreign exchange swaps	129.9	129.7
Commodities and equities swaps	3.0	2.9

Options contracts were another type of off-balance sheet product to be offered by banks during this period. Options contracts convey either the right or the obligation to buy or sell a financial instrument or futures contract on a financial instrument at a specified price by a specified future date. Options can be traded on organized exchanges or written to meet the specialized needs of the counterparties to the transaction. Options contracts were first reported on call reports in 1990; by 1991, national banks reported outstanding options contracts values at $679 billion. Approximately two-thirds of the options contracts reported were interest rate options contracts and one-third were foreign exchange contracts. Ninety-six percent of the 1991 total represented holdings of the 25 largest banks.

Holdings of National Banks of Options Contracts,
December 31, 1991
(gross amount of outstanding contracts)
(dollar amounts in billions)

	All national banks	25 largest national banks
Interest rate options	$401.4	$372.9
Foreign exchange options	236.3	236.0
Commodities and equities options	41.5	41.4

Changes in National Bank Capitalization

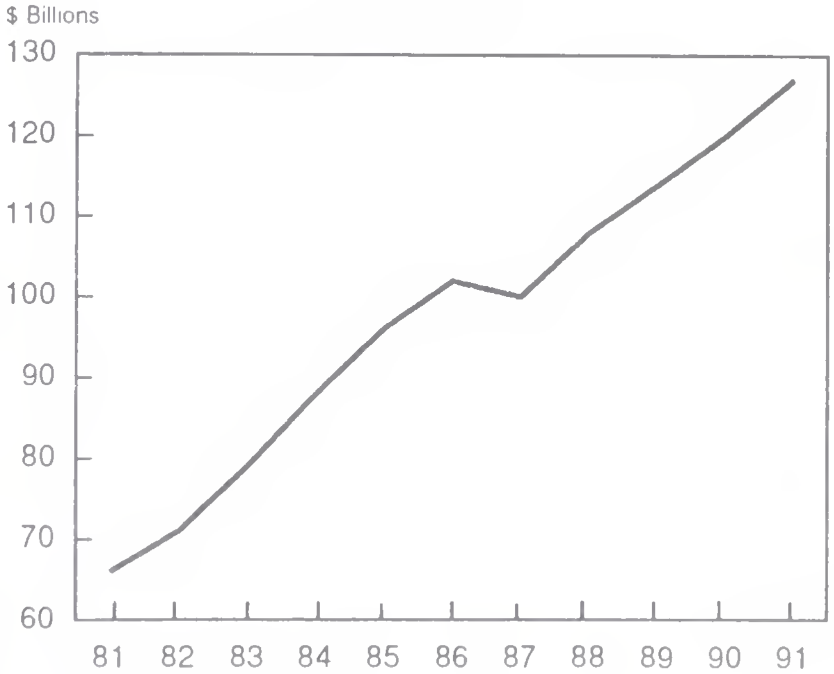
The rise in the numbers of bank failures, the decline in aggregate earnings, and the increase in credit quality problems are clear signs of weaknesses in the national banking system in the 1980s and early 1990s. However, one change in the system over this period was positive: the increase in the capitalization of national banks. Despite, or perhaps because of, disappointing performance over the last decade, national banks significantly added to their capital. Equity capital in the system almost doubled, rising from $65.7 billion in 1981 to $127.0 billion at the end of 1991. Capitalization — the ratio of equity to assets — stood at 5.47 percent in 1981, and increased to 6.41 percent at the end of 1991.

Equity

With the exception of one year, equity capital in the national banking system increased steadily from 1981 through 1991. Only in 1987 did the amount of equity capital decrease. The decline in equity capital in 1987 reflected aggressive provisioning by the largest national banks against potential losses from their loans to developing countries. Since 1987, the system has steadily built its equity capital, resulting in a 27 percent increase in the last four years.

The increase is largely due to the increase in equity capital of the largest national banks, those with at least $10 billion in assets. Their equity capital rose from $36 billion in 1987 to $54 billion in 1991, an increase of 50 percent. In addition, the equity capital in national banks with between $1 billion and $10 billion in assets increased more than 11.4 percent over this four year period, rising from $36.1 billion to $40.2 billion. Most of the increase for those banks occurred during 1991, when equity capital increased by $3.9 billion.

Equity Capital



Source: Call Reports

Capitalization

Because equity capital has grown at a faster rate than assets, capitalization, the ratio of equity to assets, for the national banking system also increased from 1981 to 1991. Between 1981 and 1985, the ratio of equity to assets for all national banks rose each year, starting at 5.47 percent and rising to 5.90 percent by 1985. After an overall decline during the next four years, to 5.75 percent, national banks' equity-to-assets ratio rose dramatically to 6.40 percent by the end of 1991. This noteworthy increase in capitalization during 1990 and 1991 reflects the combined effects of the increase in equity capital and the lack of asset growth.

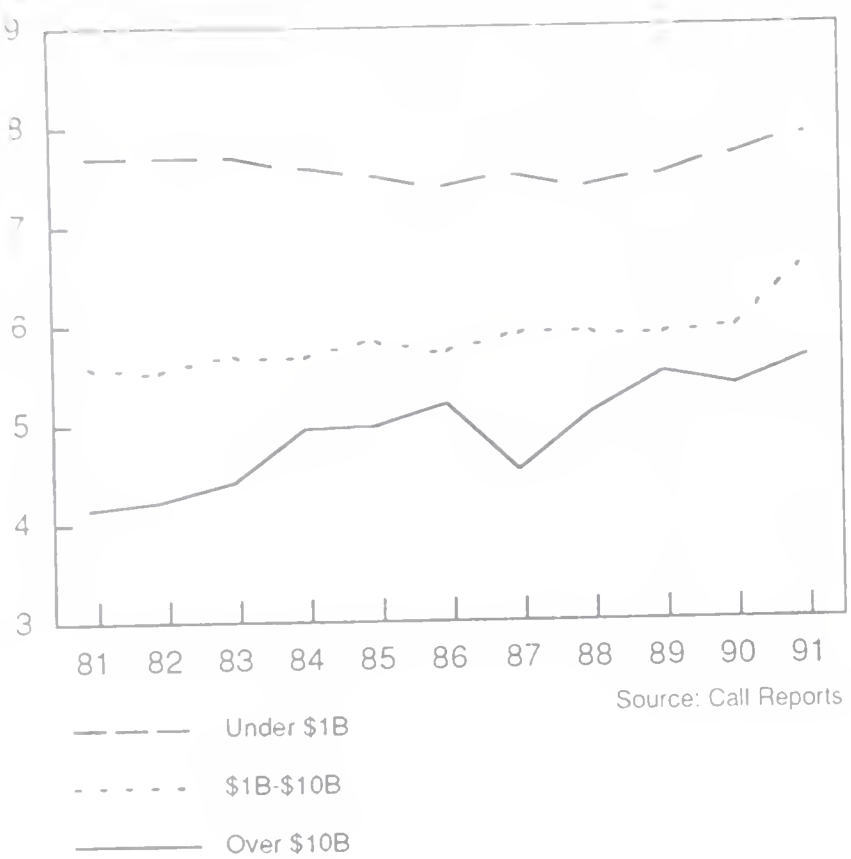
Equity to Assets

Source: Call Reports

As was the case with profitability, measures of aggregate capitalization obscure the capital strength of most banks. For example, in 1991, the aggregate ratio of equity to assets was 6.40 percent, but half of all national banks had ratios higher than 7.81 percent — the median equity-to-asset ratio. Thus these aggregate numbers actually reflect the dominance of large banks, which consistently had lower ratios of equity to assets than other banks.

The largest national banks, however, have shown the most improvement in their capitalization. In 1981, the 15 national banks with assets over $10 billion had a combined ratio of 4.13 percent compared with 6.63 percent for all other national banks. By 1991, the ratio for the 35 national banks with assets over $10 billion had risen to 5.64 percent, significantly higher than the 1981 ratio and closer to the aggregate for all other banks of 7.13 percent.

Equity to Assets by Size



In 1990, national banks began complying with new phased-in capital requirements which are to be fully implemented by the end of 1992. The requirements established minimum ratios of regulatory capital to total assets (the leverage ratio) and minimum ratios for risk-weighted assets (the risk-based capital requirement). By year-end 1991, most national banks had significantly exceeded these requirements: over 3,200 of the 3,781 national banks had leverage ratios over 5 percent and risk-based capital ratios over 10 percent. Only 137 national banks with $195 billion in assets did not meet the capital standards that are to be in effect by the end of 1992.

Conclusions

After a decade of change in the national banking system and a series of shocks to the U.S. and world economies, the national banking system, like the whole commercial banking system, had been substantially altered. The system looked different. There were fewer banks, and many of the remaining banks were organized differently, with new names and corporate affiliation. There were still many small banks, but the system was now more concentrated in bigger banks and banking companies.

The banks that remained tended to be engaged in different activities than they engaged in 10 years ago. They made more real estate loans and fewer commercial and industrial loans. They held more and different kinds of securities and engaged in off-balance sheet activities that barely existed a decade ago.

The banks that remained had the shared experience of weathering a very difficult decade. Many banks faced a slow return to strong profitability, due to the continued high levels of problem loans. Yet banks have also become better capitalized and may be better positioned to respond to new opportunities in the years ahead.

This article and the accompanying tables were prepared under the direction of Mark Winer of the Banking Research and Statistics Division. They were prepared by Jeffrey A. Brown, with assistance from Robert Dunn and Richard Nisenson.

Aggregate Statistics for National Banks, 1981-1991

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Number of Banks	4,450	4 550	4,709	4,881	4,933	4,851	4,603	4,333	4 165	3 968	3 782
Number of Banks with Losses	233	423	614	796	971	1,149	1,018	766	647	615	496
Number of Failed Banks	1	11	9	18	30	49	72	89	111	96	44
BALANCE SHEET ($ Billions)											
Assets	1,202	1,296	1 392	1,497	1,630	1,740	1,770	1,846	1,976	1,984	1,981
Loans	669	728	786	924	998	1,073	1,113	1,185	1,271	1,276	1,228
Real Estate (RE)	168	180	200	232	264	308	358	408	466	502	502
Residential	94	97	104	114	123	138	160	184	219	250	266
1-4 Family	90	92	98	107	116	128	148	172	206	237	252
Multifamily	4	5	6	7	8	10	11	12	13	13	14
Commercial	36	40	46	56	67	82	100	115	132	143	144
Construction	28	33	39	49	58	69	79	84	89	80	62
C&I	288	319	332	356	363	376	367	376	388	385	348
Consumer (Cnsmr)	111	116	135	165	195	209	215	234	252	239	234
Other	102	112	120	172	176	180	173	168	164	150	143
Noncurrent Loans	N/A	N/A	N/A	28.2	27.8	30.8	42 1	36.1	41 0	51 8	50 3
Past Due 90 Days	N/A	N/A	N/A	4.8	5.1	5.5	4.7	4 9	5 4	5 9	6 2
Nonaccrual	N/A	N/A	N/A	23.4	22.7	25.3	37 3	31.2	35 6	45.9	44 2
Noncurrent RE Loans	N/A	N/A	N/A	4 9	6.2	8.5	11.2	10.6	15.9	25.3	26.9
Noncurrent C&I Loans	N/A	N/A	N/A	10.6	10.9	11 9	17.5	13.3	13 7	17.1	15.8
Noncurrent Cnsmr Loans	N/A	N/A	N/A	1.2	1.9	2.2	2.6	2.7	3 0	3.3	3 5
Other Real Estate Owned	1.5	2.5	2 9	3.3	3.9	5.0	6 2	6.7	9 2	14 4	17 7
Securities	N/A	N/A	N/A	196.7	228.1	253.4	272.4	275.1	294 3	312 8	360.0
Liabilities	1,136	1,224	1,314	1,409	1,534	1,638	1,670	1,738	1,862	1,864	1,854
Deposits	923	991	1,078	1,150	1,240	1,321	1,348	1,415	1,503	1,556	1,570
Domestic	705	778	865	944	1,032	1,124	1,137	1,221	1,305	1,371	1,377
Foreign	218	212	214	206	208	196	211	194	198	185	193
Loan Loss Reserve	7	8	10	12	14	18	32	30	32	34	34
Equity Capital	66	71	79	88	96	102	100	108	114	120	127
Total Capital	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	149	155
INCOME STATEMENT ($ Millions)											
Net Income	8,182	8,194	8,031	8,307	9,857	9,521	-276	13,610	10,394	7,337	8,929
Net Interest Income	34,200	39,081	42,064	47,541	53,787	56,165	58,951	63,894	66,891	67,288	70,556
Interest Income	138,010	141,099	128,808	149,999	148,839	141,682	146,998	165,144	193,597	191,961	169,236
Interest Expense	103,810	102,017	86,744	102,458	95,053	85,516	88,048	101,250	126,706	124,673	98,680
Noninterest Income	N/A	N/A	N/A	17,383	20,049	22,794	25,673	27,648	32,738	34,662	36,231
Noninterest Expense	N/A	N/A	N/A	44,671	50,282	54,732	58,482	61,435	66,092	70,165	74,502
Loan Loss Provision	3,045	5,381	6,946	9,139	11,295	14,023	24,552	10,931	18,170	20,851	21,801
Securities Gains, Net	-513	-425	-12	-121	742	2,340	822	60	461	288	1,842
Extraordinary Income, Net	30	38	37	135	147	164	49	444	310	280	724
Net Loan Losses	N/A	N/A	N/A	7,417	8,574	10,362	10,618	12,414	14,960	18,817	20,939
Real Estate	N/A	N/A	N/A	534	658	1,062	1,466	1,501	2,478	4,583	5,843
C&I	N/A	N/A	N/A	4,989	4,836	5,037	4,098	4,298	3,834	5,125	6,479
Consumer	N/A	N/A	N/A	1,196	2,247	3,320	3,472	3,444	4,031	4,335	5,215
Other	N/A	N/A	N/A	697	834	944	1,582	3,171	4,617	4,773	3 401

Banking Research and Statistics
July 1992

Aggregate Ratios for National Banks, 1981-1991

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Number of Banks	4,450	4,550	4,709	4,881	4,933	4,851	4,603	4,333	4,165	3,968	3,782
Profitable Banks (%)	94.74	90.62	86.90	83.61	80.19	76.17	77.82	82.25	84.37	84.43	86.86
PERFORMANCE RATIOS (%)											
Return on Equity	13.03	11.93	10.64	9.96	10.72	9.74	-0.28	13.17	9.40	6.36	7.32
Return on Assets	0.71	0.66	0.60	0.58	0.63	0.57	-0.02	0.76	0.55	0.38	0.46
Net Interest Income/Assets	2.98	3.13	3.13	3.30	3.45	3.38	3.41	3.56	3.52	3.47	3.63
Loss Provision/Assets	0.27	0.43	0.52	0.63	0.72	0.85	1.42	0.61	0.96	1.07	1.12
Noninterest Income/Assets	N/A	N/A	N/A	1.21	1.29	1.37	1.49	1.54	1.72	1.79	1.86
Noninterest Expense/Assets	N/A	N/A	N/A	3.10	3.22	3.30	3.38	3.43	3.47	3.61	3.83
Securities Gains/Net Income	6.27	5.19	0.15	1.46	7.53	24.58	-297.79	0.44	4.44	3.92	20.63
Loss Provision/Loans	0.46	0.74	0.88	0.99	1.13	1.31	2.21	0.92	1.43	1.63	1.78
Net Loan Loss/Loans	N/A	N/A	N/A	0.80	0.86	0.97	0.95	1.05	1.18	1.48	1.71
RE Loss/RE Loans	N/A	N/A	N/A	0.23	0.25	0.34	0.41	0.37	0.53	0.91	1.16
C&I Loss/C&I Loans	N/A	N/A	N/A	1.40	1.33	1.34	1.12	1.14	0.99	1.33	1.86
Cnsmr Loss/Cnsmr Loans	N/A	N/A	N/A	0.73	1.15	1.59	1.62	1.47	1.60	1.81	2.23
Noncurrent Loans/Loans	N/A	N/A	N/A	3.06	2.78	2.87	3.78	3.04	3.22	4.06	4.10
Noncurrent RE/RE Loans	N/A	N/A	N/A	2.10	2.34	2.76	3.14	2.60	3.40	5.04	5.36
Noncurrent C&I/C&I Loans	N/A	N/A	N/A	2.98	3.01	3.16	4.76	3.55	3.53	4.44	4.55
Noncurrent Cnsmr/Cnsmr Loans	N/A	N/A	N/A	0.76	0.99	1.07	1.20	1.16	1.21	1.39	1.48
Reserve/Noncurrent Loans	N/A	N/A	N/A	41.22	51.96	58.69	76.58	82.72	78.97	65.90	67.02
PORTFOLIO RATIOS (%)											
Loans/Assets	55.68	56.16	56.48	61.75	61.22	61.65	62.87	64.17	64.32	64.29	61.97
RE Loans/Loans	25.16	24.79	25.37	25.04	26.43	28.73	32.13	34.41	36.68	39.34	40.93
C&I Loans/Loans	43.02	43.88	42.19	38.53	36.43	35.00	33.00	31.70	30.55	30.19	28.35
Cnsmr Loans/Loans	16.65	15.97	17.12	17.82	19.54	19.47	19.30	19.74	19.83	18.73	19.09
Loans/Deposits	72.45	73.45	72.94	80.35	80.44	81.26	82.51	83.71	84.58	81.99	78.19
CAPITAL RATIOS (%)											
Equity Capital/Assets	5.47	5.52	5.66	5.87	5.90	5.87	5.64	5.86	5.75	6.04	6.40
Leverage Ratio*	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	5.73	6.08
Loss Reserve/Assets	0.57	0.62	0.69	0.78	0.89	1.04	1.82	1.62	1.64	1.72	1.70
Noncurrent Loans/Equity	N/A	N/A	N/A	32.12	28.90	30.14	42.14	33.33	36.05	43.19	39.68

*Estimated

Banking Research and Statistics
July 1992

Aggregate Statistics for National Banks Under $300 Million, 1981-1991

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Number of Banks	4,118	4,196	4,309	4,450	4,465	4,362	4,122	3,835	3,653	3,453	3,262
Number of Banks with Losses	228	411	588	777	946	1,105	941	713	585	533	424
Number of Failed Banks	1	9	8	17	30	47	71	78	99	92	36
BALANCE SHEET ($ Billions)											
Assets	226.8	241.8	256.2	267.6	273.5	278.9	271.5	261.3	258.8	254.1	250.2
Loans	115.0	121.4	130.0	145.5	149.1	147.0	146.7	143.3	142.3	138.4	131.9
Real Estate (RE)	43.2	43.5	47.2	53.0	57.3	61.3	66.2	67.5	69.6	70.3	70.6
Residential	26.7	26.4	27.5	30.0	31.8	33.7	37.0	38.6	39.8	40.6	40.7
1-4 Family	25.9	25.5	26.4	28.7	30.4	32.2	35.4	37.0	38.0	38.9	38.7
Multifamily	0.8	0.9	1.1	1.3	1.4	1.5	1.6	1.6	1.7	1.7	2.0
Commercial	11.5	11.7	12.8	14.6	16.4	18.4	20.0	20.0	20.4	20.5	21.3
Construction	3.0	3.4	4.7	6.0	6.3	6.1	5.7	5.3	5.6	5.4	4.6
C&I	32.0	35.9	38.1	40.6	40.6	38.1	35.6	32.5	31.0	28.6	24.9
Consumer (Cnsmr)	30.6	31.0	32.9	35.6	36.4	34.4	32.1	31.4	30.8	28.7	26.0
Other	9.2	11.1	11.9	16.3	14.7	13.1	12.9	11.9	11.0	10.8	10.3
Noncurrent Loans	N/A	N/A	N/A	3.4	4.1	4.3	3.8	3.3	2.9	2.9	2.8
Past Due 90 Days	N/A	N/A	N/A	1.4	1.4	1.4	1.1	0.9	0.9	0.8	0.7
Nonaccrual	N/A	N/A	N/A	2.0	2.6	3.0	2.7	2.4	2.1	2.0	2.0
Noncurrent RE Loans	N/A	N/A	N/A	0.7	1.3	1.6	1.6	1.4	1.3	1.3	1.4
Noncurrent C&I Loans	N/A	N/A	N/A	1.3	2.4	2.4	1.9	1.6	1.4	1.3	1.1
Noncurrent Cnsmr Loans	N/A	N/A	N/A	0.2	0.3	0.3	0.3	0.2	0.2	0.2	0.2
Other Real Estate Owned	0.4	0.6	0.7	0.9	1.2	1.6	1.8	1.9	1.7	1.6	1.5
Securities	N/A	N/A	N/A	70.5	70.8	70.5	72.0	71.0	68.8	72.6	79.7
Liabilities	208.8	222.5	236.0	246.4	252.0	257.6	250.2	240.8	238.1	233.3	229.4
Deposits	195.0	208.8	223.5	234.4	241.2	247.5	240.8	231.7	229.5	224.9	221.5
Domestic	195.0	208.7	223.4	234.2	241.0	247.4	240.7	231.6	229.4	224.7	221.4
Foreign	0.0	0.0	0.1	0.2	0.2	0.1	0.1	0.1	0.2	0.1	0.2
Loan Loss Reserve	1.2	1.4	1.5	1.8	2.1	2.5	2.5	2.5	2.4	2.4	2.4
Equity Capital	18.1	19.3	20.2	21.2	21.5	21.3	21.3	20.5	20.7	20.8	20.8
Total Capital	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	22.6	22.5
INCOME STATEMENT ($ Millions)											
Net Income	2,225	2,209	2,171	2,021	1,793	1,299	1,417	1,466	1,946	1,868	1,969
Net Interest Income	8,755	9,496	9,778	10,291	10,753	10,332	10,271	10,006	10,201	9,903	9,846
Interest Income	24,257	26,039	24,683	27,224	26,219	24,032	22,564	22,244	23,702	23,046	21,332
Interest Expense	15,502	16,542	14,904	16,933	15,466	13,701	12,293	12,238	13,501	13,143	11,475
Noninterest Income	N/A	N/A	N/A	2,078	2,202	2,304	2,334	2,314	2,592	2,528	2,637
Noninterest Expense	N/A	N/A	N/A	8,367	8,846	9,028	8,953	8,699	8,753	8,556	8,765
Loan Loss Provision	582	939	1,147	1,524	2,091	2,460	1,798	1,511	1,265	1,258	1,112
Securities Gains, Net	-130	-62	0.2	-25	162	375	88	10	20	6	134
Extraordinary Income, Net	9	3	12	21	32	40	41	30	41	47	40
Net Loan Losses	N/A	N/A	N/A	1,144	1,670	1,957	1,502	1,218	1,064	1,001	957
Real Estate	N/A	N/A	N/A	105	172	266	281	253	230	214	204
C&I	N/A	N/A	N/A	849	1,252	1,341	919	702	577	491	459
Consumer	N/A	N/A	N/A	187	240	335	294	258	252	290	287
Other	N/A	N/A	N/A	4	6	14	8	5	6	7	7

Banking Research and Statistics
July 1992

Aggregate Ratios for National Banks Under $300 Million, 1981-1991

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Number of Banks	4,118	4,196	4,309	4,450	4,465	4,362	4,122	3,835	3,653	3,453	3,262
Profitable Banks (%)	94.44	90.11	86.29	82.45	78.68	74.51	77.10	81.33	83.90	84.48	86.97
PERFORMANCE RATIOS (%)											
Return on Equity	12.00	11.96	[illegible]	8.87	8.59	6.22	6.82	7.31	9.61	9.23	9.73
Return on Assets	1.03	0.96	0.90	0.79	0.68	0.49	0.53	0.58	0.78	0.76	0.81
Net Interest Income/Assets	4.05	4.13	4.04	4.03	4.10	3.86	3.86	3.98	4.07	4.03	4.04
Loss Provision/Assets	0.27	0.41	0.47	0.60	0.80	0.92	0.68	0.60	0.50	0.51	0.46
Noninterest Income/Assets	N/A	N/A	N/A	0.81	0.84	0.86	0.88	0.92	1.03	1.03	1.08
Noninterest Expense/Assets	N/A	N/A	N/A	3.27	3.37	3.37	3.37	3.46	3.49	3.48	3.60
Securities Gains/Net Income	5.86	2.82	0.01	1.24	9.06	28.84	6.24	0.67	1.05	0.34	6.78
Loss Provision/Loans	0.51	0.77	0.88	1.05	1.40	1.67	1.23	1.05	0.89	0.91	0.84
Net Loan Loss/Loans	N/A	N/A	N/A	0.79	1.12	1.33	1.02	0.85	0.75	0.72	0.73
RE Loss/RE Loans	N/A	N/A	N/A	0.20	0.30	0.43	0.43	0.37	0.33	0.30	0.29
C&I Loss/C&I Loans	N/A	N/A	N/A	2.09	3.08	3.52	2.58	2.16	1.86	1.72	1.84
Cnsmr Loss/Cnsmr Loans	N/A	N/A	N/A	0.52	0.66	0.98	0.92	0.82	0.82	1.01	1.10
Noncurrent Loans/Loans	N/A	N/A	N/A	2.33	2.74	2.96	2.58	2.29	2.07	2.06	2.09
Noncurrent RE/RE Loans	N/A	N/A	N/A	1.39	2.30	2.58	2.43	2.14	1.85	1.85	2.00
Noncurrent C&I/C&I Loans	N/A	N/A	N/A	3.11	6.00	6.28	5.35	4.87	4.54	4.56	4.41
Noncurrent Cnsmr/Cnsmr Loans	N/A	N/A	N/A	0.68	0.82	0.99	0.83	0.75	0.74	0.82	0.90
Reserve/Noncurrent Loans	N/A	N/A	N/A	54.20	51.94	56.40	66.82	76.45	81.67	84.13	87.68
PORTFOLIO RATIOS (%)											
Loans/Assets	50.69	50.19	50.74	54.38	54.51	52.68	54.05	54.85	54.99	54.46	52.70
RE Loans/Loans	37.57	35.80	36.30	36.45	38.44	41.74	45.11	47.12	48.88	50.81	53.55
C&I Loans/Loans	27.81	29.57	29.28	27.88	27.25	25.93	24.24	22.65	21.78	20.67	18.88
Cnsmr Loans/Loans	26.62	25.50	25.28	24.44	24.44	23.39	21.88	21.91	21.63	20.73	19.73
Loans/Deposits	58.97	58.13	58.16	62.09	61.81	59.37	60.94	61.86	62.01	61.53	59.54
CAPITAL RATIOS (%)											
Equity Capital/Assets	7.97	7.97	7.90	7.92	7.86	7.63	7.84	7.83	8.01	8.17	8.32
Leverage Ratio*	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	8.22	8.28
Loss Reserve/Assets	0.54	0.56	0.60	0.69	0.78	0.88	0.93	0.96	0.93	0.95	0.96
Noncurrent Loans/Equity	N/A	N/A	N/A	15.97	18.99	20.41	17.82	16.05	14.20	13.76	13.22

*Estimated
Banking Research and Statistics
July 1992

Aggregate Statistics for National Banks $300 Million - $1 Billion, 1981-1991

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Number of Banks	196	201	231	247	266	278	270	281	288	308	317
Number of Banks with Losses	3	6	13	10	18	28	37	34	28	35	34
Number of Failed Banks	0	2	0	0	0	2	1	6	9	3	3
BALANCE SHEET ($ Billions)											
Assets	105.0	107.9	119.4	127.2	135.4	140.9	137.8	142.1	145.7	159.8	164.1
Loans	52.8	53.3	60.6	74.0	80.1	83.8	84.6	90.2	92.7	100.4	99.5
Real Estate (RE)	18.1	18.2	20.5	22.4	25.6	28.7	32.9	37.8	40.0	46.0	49.7
Residential	10.0	9.8	10.8	11.3	12.5	13.3	16.0	18.7	21.1	25.5	28.8
1-4 Family	9.4	9.3	10.2	10.6	11.7	12.4	15.1	17.6	20.0	24.2	27.3
Multifamily	0.6	0.6	0.6	0.6	0.8	0.9	0.9	1.1	1.1	1.3	1.5
Commercial	5.4	5.5	6.2	7.0	8.4	10.6	11.6	13.5	13.6	15.3	16.5
Construction	2.6	2.7	3.2	3.8	4.4	4.4	4.8	5.0	4.7	4.4	3.6
C&I	18.6	18.7	21.1	23.5	24.1	23.4	21.9	22.1	21.9	22.4	19.9
Consumer (Cnsmr)	13.1	13.0	15.7	20.0	21.9	23.4	21.8	22.9	24.5	25.3	23.5
Other	3.0	3.4	3.4	8.0	8.6	8.3	8.1	7.4	6.3	6.7	6.4
Noncurrent Loans	N/A	N/A	N/A	1.5	1.8	2.0	2.1	1.9	1.8	2.2	2.2
Past Due 90 Days	N/A	N/A	N/A	0.5	0.5	0.5	0.4	0.5	0.6	0.5	0.5
Nonaccrual	N/A	N/A	N/A	1.0	1.3	1.4	1.6	1.4	1.3	1.6	1.8
Noncurrent RE Loans	N/A	N/A	N/A	0.4	0.6	0.8	1.0	1.0	0.9	1.1	1.3
Noncurrent C&I Loans	N/A	N/A	N/A	0.8	0.8	0.8	0.8	0.6	0.6	0.7	0.6
Noncurrent Cnsmr Loans	N/A	N/A	N/A	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other Real Estate Owned	0.2	0.2	0.3	0.3	0.3	0.5	0.7	0.8	0.7	1.0	1.0
Securities	N/A	N/A	N/A	25.2	27.0	26.7	26.3	27.4	27.6	32.9	38.4
Liabilities	97.9	100.6	111.3	118.7	126.3	131.7	128.7	133.0	135.8	148.5	152.2
Deposits	84.3	86.7	98.8	104.8	111.7	117.9	114.9	119.5	121.2	133.4	139.0
Domestic	83.6	86.4	98.5	104.5	111.4	117.6	114.5	119.2	120.9	133.1	138.8
Foreign	0.6	0.3	0.3	0.2	0.3	0.3	0.4	0.3	0.3	0.3	0.3
Loan Loss Reserve	0.6	0.7	0.8	0.9	1.1	1.4	1.4	1.6	1.6	1.9	2.0
Equity Capital	7.1	7.3	8.0	8.6	9.1	9.2	9.1	9.1	9.8	11.2	11.9
Total Capital	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	12.2	13.0
INCOME STATEMENT ($ Millions)											
Net Income	895	805	894	1,091	930	844	755	815	1,171	1,150	1,200
Net Interest Income	3,759	3,896	4,216	4,544	4,935	5,137	5,020	5,265	5,638	6,147	6,469
Interest Income	11,140	11,101	10,845	12,257	12,140	11,740	11,065	11,945	13,537	14,448	13,880
Interest Expense	7,380	7,205	6,629	7,713	7,205	6,604	6,045	6,680	7,899	8,300	7,411
Noninterest Income	N/A	N/A	N/A	1,395	1,506	1,620	1,572	1,572	1,678	1,969	2,179
Noninterest Expense	N/A	N/A	N/A	4,091	4,505	4,704	4,569	4,724	4,769	5,355	5,706
Loan Loss Provision	248	466	516	531	881	1,165	1,025	925	918	1,168	1,376
Securities Gains, Net	-46	-64	-4	-15	65	165	67	12	4	11	122
Extraordinary Income, Net	14	3	2	12	15	13	12	9	9	10	7
Net Loan Losses	N/A	N/A	N/A	400	653	888	834	773	756	942	1,191
Real Estate	N/A	N/A	N/A	31	74	100	162	168	155	221	245
C&I	N/A	N/A	N/A	233	296	366	342	318	223	320	448
Consumer	N/A	N/A	N/A	104	234	363	289	261	349	383	448
Other	N/A	N/A	N/A	31	48	59	41	25	28	18	50

Banking Research and Statistics
July 1992

Aggregate Ratios for National Banks $300 Million - $1 Billion, 1981-1991

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Number of Banks	196	201	231	247	266	278	270	281	288	308	317
Profitable Banks (%)	98.47	97.02	94.37	95.95	93.23	89.93	86.30	87.90	90.28	88.64	89.27
PERFORMANCE RATIOS (%)											
Return on Equity	13.26	11.66	11.67	13.39	10.76	9.47	8.60	9.17	12.41	10.78	10.55
Return on Assets	0.90	0.79	0.79	0.91	0.73	0.63	0.57	0.60	0.83	0.75	0.75
Net Interest Income/Assets	3.78	3.82	3.74	3.78	3.86	3.84	3.77	3.90	4.01	4.02	4.05
Loss Provision/Assets	0.25	0.46	0.46	0.44	0.69	0.87	0.77	0.69	0.65	0.76	0.86
Noninterest Income/Assets	N/A	N/A	N/A	1.16	1.18	1.21	1.18	1.17	1.19	1.29	1.36
Noninterest Expense/Assets	N/A	N/A	N/A	3.40	3.53	3.51	3.43	3.50	3.39	3.50	3.57
Securities Gains/Net Income	-5.11	-7.95	-0.43	-1.37	6.99	19.55	8.88	1.43	0.34	0.99	10.21
Loss Provision/Loans	0.47	0.87	0.85	0.72	1.10	1.39	1.21	1.03	0.99	1.16	1.38
Net Loan Loss/Loans	N/A	N/A	N/A	0.54	0.82	1.06	0.99	0.86	0.82	0.94	1.20
RE Loss/RE Loans	N/A	N/A	N/A	0.14	0.29	0.35	0.49	0.45	0.39	0.48	0.49
C&I Loss/C&I Loans	N/A	N/A	N/A	0.99	1.23	1.56	1.57	1.43	1.02	1.43	2.25
Cnsmr Loss/Cnsmr Loans	N/A	N/A	N/A	0.52	1.07	1.55	1.33	1.14	1.43	1.51	1.90
Noncurrent Loans/Loans	N/A	N/A	N/A	2.00	2.22	2.34	2.44	2.05	1.98	2.14	2.25
Noncurrent RE/RE Loans	N/A	N/A	N/A	1.93	2.31	2.77	3.05	2.56	2.25	2.43	2.55
Noncurrent C&I/C&I Loans	N/A	N/A	N/A	3.40	3.50	3.47	3.51	2.77	2.88	3.21	3.20
Noncurrent Cnsmr/Cnsmr Loans	N/A	N/A	N/A	0.69	0.94	0.97	0.80	0.78	0.98	0.98	0.93
Reserve/Noncurrent Loans	N/A	N/A	N/A	62.33	62.69	69.32	69.23	84.06	88.17	86.98	91.04
PORTFOLIO RATIOS (%)											
Loans/Assets	50.34	49.39	50.75	58.14	59.19	59.50	61.35	63.44	63.63	62.82	60.65
RE Loans/Loans	34.33	34.16	33.82	30.24	31.96	34.25	38.86	41.92	43.18	45.87	49.92
C&I Loans/Loans	35.24	35.08	34.75	31.83	30.05	27.96	25.87	24.56	23.65	22.27	19.96
Cnsmr Loans/Loans	24.73	24.32	25.87	27.10	27.29	27.87	25.73	25.36	26.42	25.20	23.66
Loans/Deposits	62.71	61.44	61.34	70.62	71.73	71.11	73.59	75.45	76.46	75.27	71.59
CAPITAL RATIOS (%)											
Equity Capital/Assets	6.73	6.73	6.73	6.74	6.70	6.55	6.60	6.43	6.74	7.04	7.24
Leverage Ratio*	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	6.78	7.03
Loss Reserve/Assets	0.58	0.63	0.66	0.72	0.83	0.96	1.04	1.09	1.11	1.17	1.24
Noncurrent Loans/Equity	N/A	N/A	N/A	17.22	19.64	21.23	22.72	20.23	18.72	19.13	18.84

*Estimated

Banking Research and Statistics
July 1992

Aggregate Statistics for National Banks $1 Billion - $10 Billion, 1981-1991

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Number of Banks	121	138	153	167	182	185	182	186	192	171	168
Number of Banks with Losses	2	6	10	6	6	15	26	17	26	36	29
Number of Failed Banks	0	0	1	0	0	0	0	3	3	1	3
BALANCE SHEET ($ Bilions)											
Assets	323.9	378.9	435.8	510.8	566.1	573.6	566.6	609.3	669.5	609.8	609.2
Loans	165.1	195.0	229.2	311.5	353.3	359.1	367.8	404.8	447.0	392.5	377.2
Real Estate (RE)	41.0	50.6	59.8	77.8	88.6	102.5	119.4	139.6	160.4	148.9	145.8
Residential	22.5	26.4	29.4	35.5	37.5	41.6	47.2	55.9	67.5	67.4	73.2
1-4 Family	21.4	25.1	27.9	33.6	35.1	38.6	43.9	52.5	63.5	63.6	68.9
Multifamily	1.0	1.4	1.6	2.0	2.4	3.0	3.3	3.4	4.0	3.8	4.3
Commercial	9.4	12.3	15.3	20.7	24.3	30.5	38.5	47.0	54.1	51.4	51.5
Construction	8.7	11.3	14.3	20.6	25.7	29.3	32.2	35.1	37.0	28.3	19.6
C&I	64.5	76.4	84.0	106.0	114.6	117.0	111.7	119.7	124.0	111.0	93.8
Consumer (Cnsmr)	34.9	40.1	50.7	67.9	85.7	79.7	87.8	100.6	115.6	94.2	100.8
Other	24.6	28.0	34.7	59.8	64.4	60.0	49.0	44.9	47.0	38.4	36.9
Noncurrent Loans	N/A	N/A	N/A	7.8	7.9	8.2	9.5	8.6	10.9	14.1	12.7
Past Due 90 Days	N/A	N/A	N/A	1.3	1.7	1.9	1.6	1.7	2.0	2.0	2.3
Nonaccrual	N/A	N/A	N/A	6.4	6.2	6.3	7.9	7.0	8.9	12.1	10.5
Noncurrent RE Loans	N/A	N/A	N/A	1.5	1.9	2.6	3.7	3.9	5.8	7.9	6.8
Noncurrent C&I Loans	N/A	N/A	N/A	3.8	3.4	3.5	3.4	2.7	3.0	4.5	3.6
Noncurrent Cnsmr Loans	N/A	N/A	N/A	0.5	1.0	0.9	0.8	0.9	1.1	1.2	1.5
Other Real Estate Owned	0.4	0.7	0.8	1.0	1.1	1.3	1.8	2.2	3.0	5.1	5.4
Securities	N/A	N/A	N/A	69.3	81.2	88.0	91.6	94.9	104.6	103.6	123.1
Liabilities	305.8	357.9	410.9	481.8	533.1	540.7	533.2	573.2	630.8	573.4	569.0
Deposits	236.7	278.7	323.5	382.1	418.8	428.1	427.2	460.5	502.1	478.6	475.2
Domestic	210.3	251.7	295.9	357.8	394.7	410.1	410.2	445.9	486.9	468.4	466.5
Foreign	26.5	27.1	27.6	24.4	24.2	18.0	17.0	14.6	15.2	10.2	8.8
Loan Loss Reserve	2.0	2.6	3.3	4.2	5.0	5.6	7.7	7.7	9.5	10.6	10.9
Equity Capital	18.1	21.0	24.9	29.0	33.0	32.8	33.4	36.1	38.6	36.3	40.2
Total Capital	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	42.3	45.1
INCOME STATEMENT ($ Millions)											
Net Income	2,230	2,339	2,533	3,812	4,463	3,653	2,311	4,007	3,427	2,037	3,230
Net Interest Income	9,553	11,977	13,494	16,458	19,216	18,504	19,999	22,256	24,494	22,278	23,619
Interest Income	34,821	38,657	37,542	47,425	48,583	43,882	44,640	51,512	61,632	55,356	50,535
Interest Expense	25,268	26,680	24,048	30,966	29,367	25,379	24,640	29,257	37,138	33,078	26,916
Noninterest Income	N/A	N/A	N/A	6,883	8,033	7,791	7,893	8,688	10,009	10,263	12,761
Noninterest Expense	N/A	N/A	N/A	16,369	18,497	18,227	19,024	20,659	22,757	21,614	24,784
Loan Loss Provision	914	1,749	2,243	2,463	3,342	4,221	5,785	4,550	6,832	8,360	7,430
Securities Gains, Net	−223	−219	−40	−77	121	619	181	75	66	102	673
Extraordinary Income, Net	7	1	24	102	74	28	20	41	58	41	−1
Net Loan Losses	N/A	N/A	N/A	1,970	2,576	3,026	3,654	4,646	4,892	5,731	6,467
Real Estate	N/A	N/A	N/A	103	145	262	447	667	1,211	1,797	1,646
C&I	N/A	N/A	N/A	1,198	1,093	1,236	1,166	1,571	1,277	1,724	1,747
Consumer	N/A	N/A	N/A	476	1,070	1,167	1,427	1,567	1,951	1,876	2,662
Other	N/A	N/A	N/A	193	268	360	614	841	453	335	412

Banking Research and Statistics
July 1992

Aggregate Ratios for National Banks $1 Billion - $10 Billion, 1981-1991

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Number of Banks	121	138	153	167	182	185	182	186	192	171	168
Profitable Banks (%)	98.35	95.65	93.46	96.41	96.70	91.89	85.71	90.86	86.46	78.95	82.74
PERFORMANCE RATIOS (%)											
Return on Equity	13.03	11.62	10.83	14.19	14.45	11.83	7.25	11.67	9.20	5.75	8.48
Return on Assets	0.73	0.65	0.62	0.80	0.84	0.68	0.42	0.69	0.54	0.34	0.54
Net Interest Income/Assets	3.13	3.32	3.28	3.47	3.60	3.45	3.67	3.84	3.84	3.74	3.96
Loan Provision/Assets	0.30	0.49	0.55	0.52	0.63	0.79	1.06	0.78	1.07	1.40	1.25
Noninterest Income/Assets	N/A	N/A	N/A	1.45	1.51	1.45	1.45	1.50	1.57	1.72	2.14
Noninterest Expense/Assets	N/A	N/A	N/A	3.45	3.47	3.40	3.49	3.56	3.56	3.63	4.16
Securities Gains/Net Income	10.01	-9.37	-1.56	-2.01	2.71	16.94	7.85	1.87	1.93	5.03	20.83
Loss Provision/Loans	0.55	0.90	0.98	0.79	0.95	1.18	1.57	1.12	1.53	2.13	1.97
Net Loan Loss/Loans	N/A	N/A	N/A	0.63	0.73	0.84	0.99	1.15	1.09	1.46	1.71
RE Loss/RE Loans	N/A	N/A	N/A	0.13	0.16	0.26	0.37	0.48	0.75	1.21	1.13
C&I Loss/C&I Loans	N/A	N/A	N/A	1.13	0.95	1.06	1.04	1.31	1.03	1.55	1.86
Cnsmr Loss/Cnsmr Loans	N/A	N/A	N/A	0.70	1.25	1.47	1.63	1.56	1.69	1.99	2.64
Noncurrent Loans/Loans	N/A	N/A	N/A	2.49	2.23	2.27	2.58	2.13	2.43	3.60	3.38
Noncurrent RE/RE Loans	N/A	N/A	N/A	1.97	2.13	2.58	3.13	2.78	3.63	5.33	4.68
Noncurrent C&I/C&I Loans	N/A	N/A	N/A	3.58	2.97	2.95	3.05	2.27	2.39	4.03	3.88
Noncurrent Cnsmr/Cnsmr Loans	N/A	N/A	N/A	0.81	1.12	1.08	0.95	0.94	0.99	1.26	1.50
Reserve/Noncurrent Loans	N/A	N/A	N/A	53.87	63.16	68.85	81.03	89.15	87.53	74.69	85.63
PORTFOLIO RATIOS (%)											
Loans/Assets	50.96	51.46	52.59	60.98	62.40	62.61	64.92	66.43	66.76	64.37	61.92
RE Loans/Loans	24.86	25.95	26.07	24.97	25.08	28.55	32.46	34.47	35.89	37.93	38.64
C&I Loans/Loans	39.07	39.16	36.64	34.02	32.42	32.58	30.35	29.58	27.75	28.28	24.86
Cnsmr Loans/Loans	21.15	20.54	22.13	21.79	24.26	22.18	23.86	24.86	25.86	24.00	26.73
Loans/Deposits	69.73	69.96	70.85	81.52	84.35	83.89	86.11	87.90	89.01	82.01	79.37
CAPITAL RATIOS (%)											
Equity Capital/Assets	5.58	5.54	5.71	5.67	5.83	5.72	5.89	5.92	5.76	5.96	6.60
Leverage Ratio*	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	5.71	6.30
Loss Reserve/Assets	0.62	0.69	0.76	0.82	0.88	0.98	1.36	1.26	1.42	1.73	1.79
Noncurrent Loans/Equity	N/A	N/A	N/A	26.77	23.87	24.86	28.46	23.89	28.15	38.94	31.71

*Estimated

Banking Research and Statistics
July 1992

Aggregate Statistics for National Banks Over $10 Billion, 1981-1991

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Number of Banks	15	15	16	17	20	26	29	31	32	36	35
Number of Banks with Losses	0	0	3	3	1	1	14	2	8	11	9
Number of Failed Banks	0	0	0	1	0	0	0	2	0	0	2
BALANCE SHEET ($ Billions)											
Assets	545.9	566.9	581.1	591.5	654.9	747.1	794.0	833.4	902.1	960.3	957.4
Loans	336.2	357.9	366.7	393.4	415.3	483.1	513.5	546.3	589.1	644.2	618.9
Real Estate (RE)	65.9	68.1	72.1	78.3	92.2	115.8	139.1	162.8	196.2	236.6	236.4
Residential	34.4	34.1	36.0	36.8	41.7	49.1	59.7	70.8	90.5	116.3	123.8
1-4 Family	32.7	32.4	33.6	34.2	38.6	44.6	54.2	65.1	84.2	110.4	117.4
Multifamily	1.7	1.7	2.4	2.6	3.1	4.5	5.6	5.7	6.3	6.0	6.4
Commercial	10.1	10.4	11.9	14.0	17.6	22.3	30.0	34.3	43.6	55.4	55.1
Construction	13.3	15.5	16.6	18.2	21.4	29.5	35.8	38.2	41.7	41.5	34.5
C&I	172.7	188.3	188.8	186.1	184.2	197.0	198.1	201.3	211.3	223.1	209.4
Consumer (Cnsmr)	32.8	32.2	35.4	41.3	51.0	71.5	73.1	79.0	81.2	90.7	83.9
Other	64.7	69.3	70.5	87.8	87.8	98.9	103.1	103.3	100.3	93.8	89.2
Noncurrent Loans	N/A	N/A	N/A	15.6	14.0	16.4	26.7	22.3	25.3	32.6	32.6
Past Due 90 Days	N/A	N/A	N/A	1.7	1.4	1.7	1.6	1.8	2.0	2.5	2.7
Nonaccrual	N/A	N/A	N/A	13.9	12.6	14.6	25.1	20.5	23.4	30.1	29.9
Noncurrent RE Loans	N/A	N/A	N/A	2.2	2.4	3.5	4.9	4.3	7.9	14.9	17.4
Noncurrent C&I Loans	N/A	N/A	N/A	4.8	4.3	5.2	11.4	8.4	8.7	10.6	10.4
Noncurrent Cnsmr Loans	N/A	N/A	N/A	0.3	0.5	0.8	1.3	1.3	1.4	1.7	1.5
Other Real Estate Owned	0.5	1.0	1.0	1.1	1.2	1.6	1.8	1.9	3.8	6.8	9.7
Securities	N/A	N/A	N/A	31.6	49.1	68.2	82.4	81.8	93.4	103.7	118.8
Liabilities	523.4	543.0	555.4	562.3	622.3	708.1	757.9	791.0	857.6	908.7	903.5
Deposits	407.5	416.3	432.5	429.2	468.6	527.0	565.6	603.4	649.9	718.7	734.1
Domestic	216.4	231.4	246.8	248.0	284.9	349.0	372.1	424.0	467.6	544.6	550.4
Foreign	191.1	184.9	185.7	181.2	183.7	178.0	193.6	179.4	182.3	174.1	183.7
Loan Loss Reserve	3.0	3.4	4.0	4.7	6.2	8.7	20.5	18.1	18.8	19.3	18.4
Equity Capital	22.5	23.9	25.7	29.2	32.6	38.9	36.0	42.5	44.5	51.6	54.0
Total Capital	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	71.9	74.2
INCOME STATEMENT ($ Millions)											
Net Income	2,832	2,841	2,433	1,383	2,672	3,725	-4,760	7,322	3,850	2,283	2,530
Net Interest Income	12,132	13,711	14,575	16,248	18,882	22,194	23,660	26,368	26,559	28,960	30,621
Interest Income	67,792	65,301	55,738	63,093	61,898	62,027	68,729	79,443	94,726	99,112	83,498
Interest Expense	55,660	51,590	41,163	46,845	43,016	39,834	45,070	53,075	68,167	70,151	52,877
Noninterest Income	N/A	N/A	N/A	7,027	8,308	11,079	13,874	15,074	18,459	19,902	18,655
Noninterest Expense	N/A	N/A	N/A	15,844	18,434	22,772	25,936	27,353	29,813	34,640	35,247
Loan Loss Provision	1,300	2,226	3,040	4,621	4,981	6,178	15,945	3,944	9,155	10,065	11,884
Securities Gains, Net	-114	-79	31	-5	394	1,182	486	-36	371	168	913
Extraordinary Income, Net	0	31	0	0	26	83	-24	363	203	182	678
Net Loan Losses	N/A	N/A	N/A	3,903	3,675	4,491	4,628	5,777	8,248	11,142	12,324
Real Estate	N/A	N/A	N/A	295	267	433	576	413	882	2,351	3,748
C&I	N/A	N/A	N/A	2,709	2,195	2,093	1,670	1,708	1,758	2,591	3,826
Consumer	N/A	N/A	N/A	429	703	1,454	1,462	1,357	1,478	1,786	1,818
Other	N/A	N/A	N/A	469	511	510	919	2,300	4,130	4,414	2,932

Banking Research and Statistics
July 1992

Aggregate Ratios for National Banks Over $10 Billion, 1981-1991

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Number of Banks	15	15	16	17	20	26	29	31	32	36	35
Profitable Banks (%)	100.00	100.00	81.25	82.35	95.00	96.15	51.72	93.55	71.88	69.44	74.29
PERFORMANCE RATIOS (%)											
Return on Equity	13.06	12.27	9.72	4.95	8.48	10.06	-12.49	18.28	8.82	4.65	4.84
Return on Assets	0.54	0.51	0.42	0.23	0.42	0.52	-0.61	0.89	0.44	0.24	0.27
Net Interest Income/Assets	2.31	2.47	2.52	2.75	2.97	3.08	3.02	3.19	3.04	3.06	3.23
Loss Provision /Assets	0.25	0.40	0.53	0.78	0.78	0.86	2.03	0.48	1.05	1.06	1.25
Noninterest Income/Assets	N/A	N/A	N/A	1.19	1.31	1.54	1.77	1.82	2.12	2.10	1.97
Noninterest Expense Assets	N/A	N/A	N/A	2.68	2.90	3.16	3.31	3.31	3.42	3.66	3.72
Securities Gains/Net Income	4.01	2.79	1.29	-0.33	14.74	31.72	-10.20	-0.49	9.63	7.34	36.08
Loss Provision/Loans	0.39	0.62	0.83	1.17	1.20	1.28	3.10	0.72	1.55	1.56	1.92
Net Loan Loss/Loans	N/A	N/A	N/A	0.99	0.89	0.93	0.90	1.06	1.40	1.73	1.99
RE Loss/RE Loans	N/A	N/A	N/A	0.38	0.29	0.37	0.41	0.25	0.45	0.99	1.59
C&I Loss/C&I Loans	N/A	N/A	N/A	1.46	1.19	1.06	0.84	0.85	0.83	1.16	1.83
Cnsmr Loss/Cnsmr Loans	N/A	N/A	N/A	1.04	1.38	2.03	2.00	1.72	1.82	1.97	2.17
Noncurrent Loans/Loans	N/A	N/A	N/A	3.97	3.38	3.38	5.20	4.08	4.30	5.07	5.27
Noncurrent RE/RE Loans	N/A	N/A	N/A	2.76	2.58	3.01	3.51	2.65	4.01	6.30	7.37
Noncurrent C&I/C&I Loans	N/A	N/A	N/A	2.56	2.31	2.64	5.76	4.18	4.12	4.74	4.99
Noncurrent Cnsmr/Cnsmr Loans	N/A	N/A	N/A	0.77	0.90	1.13	1.78	1.70	1.76	1.83	1.78
Reserve/Noncurrent Loans	N/A	N/A	N/A	30.14	44.31	52.97	76.95	81.04	74.32	59.11	56.35
PORTFOLIO RATIOS (%)											
Loans/Assets	61.58	63.13	63.12	66.52	63.41	64.67	64.68	65.55	65.30	67.09	64.65
RE Loans/Loans	19.62	19.02	19.65	19.90	22.20	23.96	27.09	29.79	33.31	36.72	38.20
C&I Loans/Loans	51.38	52.60	51.47	47.31	44.36	40.77	38.58	36.84	35.87	34.64	33.83
Cnsmr Loans/Loans	9.75	9.01	9.66	10.49	12.28	14.81	14.24	14.46	13.79	14.08	13.56
Loans/Deposits	82.50	85.98	84.80	91.66	88.62	91.67	90.79	90.54	90.64	89.63	84.31
CAPITAL RATIOS (%)											
Equity Capital/Assets	4.13	4.22	4.42	4.94	4.97	5.21	4.54	5.09	4.94	5.37	5.64
Leverage Ratio*	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	4.94	5.23
Loss Reserve/Assets	0.55	0.61	0.69	0.80	0.95	1.16	2.59	2.17	2.09	2.01	1.92
Noncurrent Loans/Equity	N/A	N/A	N/A	53.53	43.12	42.05	74.11	52.52	56.87	63.28	60.41

*Estimated

Banking Research and Statistics

July 1992

Special Supervision and Enforcement Involving the Office of the Comptroller of the Currency and the National Banking System, 1981-1991

Introduction

In the late 1970s and early 1980s, the Office of the Comptroller of the Currency's (OCC) special supervision and enforcement activities related primarily to rehabilitating national banks experiencing problems and holding individuals accountable for their actions. Bank failures were rare in these years and posed no real threat to the safety and soundness of the national banking system.

Similar conditions existed in the rest of the commercial banking system. Unfortunately, by the mid-1980s commercial banks began failing in record numbers, as various sectors of the United States — the Midwest, Southwest, Northeast, and, most recently, the West — struggled with deteriorating economies.

In response to the increased problems in the nation's commercial banking industry, the federal bank regulatory agencies developed new strategies to deal with problem institutions. Some of these strategies, such as emergency acquisition authority, bridge banks, and strengthened conservatorship authority, provided the agencies with additional flexibility to deal quickly with problems involving faltering institutions. Others, such as expanded enforcement and disclosure authority, enabled the agencies to correct problems in unhealthy, but solvent, institutions and to penalize individuals who abused their fiduciary responsibilities.

At the OCC, additional initiatives were taken. A study of failed, rehabilitated, and healthy national banks was released to help bank examiners and the industry identify reasons for bank failures. Other reports followed detailing common deficiencies found in poorly managed institutions. The reports raised cautionary "red flags" for healthy institutions to help them avoid the problems that had beset weaker institutions.

On the enforcement side, the OCC's enforcement program became an integral part of effective bank supervision. Enforcement actions were utilized with increasing frequency during the decade, and some of these actions required the OCC to defend challenges to its enforcement authority in court. During this decade the OCC took a strong stand against bank fraud and other criminal activity in national banks, especially insider abuse. In the closing years of the period, the OCC implemented significantly enhanced enforcement authority authorized by Congress under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and other legislation. The OCC also revised its enforcement policy to ensure that national banks with similar problems would be treated consistently throughout the U.S. and to specify instances in which it would have a strong bias for taking formal enforcement actions.

In some cases, supervisory and enforcement actions were unable to help institutions return to a safe and sound condition. Accordingly, the OCC took several other steps either to assist in the recapitalization of the bank or to close the institution. It implemented an "assisting troubled banks" program to help certain troubled banks obtain outside sources of capital before failure was a virtual certainty. The OCC also published an insolvency rule to enhance its flexibility to close a national bank when its equity capital was exhausted.

This article will review some of the OCC's initiatives to rehabilitate problem banks while preserving the overall health of the banking industry. It will also provide a summary of key enforcement activities and litigation involving the OCC during the years 1981-1991.

Identifying Problems Facing National Banks

As the numbers of bank failures and problem banks began to rise in regions of the country experiencing economic disruptions, the OCC initiated an in-depth study to determine why banks fail. The results of the study, published in 1988 in a booklet entitled *Bank Failure: An Examination of the Factors Contributing to the Failure of National Banks*, covered the years 1979 through 1987. The study analyzed 94 percent of national banks that failed during this period to identify characteristics and conditions present when the banks deteriorated. The study also evaluated other banks of comparable size, in the same areas, during the same time period. Some of these banks remained healthy, while others undertook successful rehabilitative measures and were restored to a safe and sound condition.

The study evaluated each bank's performance in eight broad categories: policy, planning, and management quality; audits, controls, and systems; asset quality;

liquidity and funds management, non-funding expenses, insider abuse, fraud, and the economic environment. The major finding of the study: although economic decline contributed to the difficulties of many of the failed and problem banks, economic factors were rarely the sole cause of the bank's problems. Instead, poor management and other internal weaknesses caused by a bank's management and board of directors were the common denominator of failed and problem banks.

The OCC's experience also enabled it to provide insight as to common deficiencies found in weak institutions that their stronger counterparts avoided. In 1987 the agency published *The Director's Book: The Role of a National Bank Director* to provide general guidance to directors of national banks about their duties and responsibilities. *A Director's Guide to Bank Board Reports: Red Flags and Other Points of Interest* followed in 1989. Both reports identified the following as being prevalent in problem banks:

- uninformed or inattentive board and management who fail, among other things, to assure the bank has adequate internal controls, satisfactory audit procedures, or adequate problem loan identification systems;
- an overly aggressive board or management who institute an aggressive growth policy for the bank without adequate controls;
- a weak or abusive chief executive officer who may lack capability, experience, or integrity;
- poor lending practices such as excessive collateral-based lending, concentrations of credit, or out-of-area lending; and,
- insider abuse or fraud.

Enforcement Activities Involving the OCC

Overview

During this period, the OCC's enforcement program became an integral part of effective bank supervision. Enforcement actions were utilized with increasing frequency during the decade to handle the rising number of problems in national banks. In 1981, the agency took a total of 154 enforcement actions. The number increased steadily, reaching more than 600 actions in [illegible]. The number of actions remained at a consistently high level for the rest of the decade; during 1991, the agency [illegible] enforcement actions (formal and informal). [illegible] hearings to resolve contested [illegible] formal actions [illegible] during this period. In the early 1980s, in addition to ruling on numerous motions filed by the parties, the Comptroller regularly issued between one and three final decisions each year; however, in 1988-1989 the Comptroller issued 17 final decisions.

The OCC operated in the early 1980s under an enforcement policy that was based on a bank's composite CAMEL rating (Capital, Assets, Management, Earnings and Liquidity). This policy generally required that formal remedial actions be taken on any 3-, 4-, or 5-rated bank. At that time, the number of such banks was relatively small. However, during the 1980s the number of troubled institutions grew, and the nature of problems in banks grew more complex. The OCC adopted a more flexible policy in 1987 to provide more discretion to deal with problem institutions. The policy afforded the OCC the opportunity to use a wider variety of supervisory responses, including informal enforcement actions. Like its predecessor, this policy also required a strong enforcement action in any case involving serious insider abuse, significant compliance problems or serious violations of law, or when prior supervisory actions had proven unsuccessful. In such cases, the policy established a strong bias in favor of formal enforcement actions. The OCC adopted a similar policy for securities enforcement actions in 1988, i.e., to take formal action when customer abuse, fraud, or extensive compliance problems were found.

Late in 1991, the OCC refined its enforcement policy to make more effective use of enforcement actions. The policy said that a strong bias exists to take formal enforcement actions in national banks with CAMEL ratings of 4 and 5, the two most troubled categories. This policy also signaled that the OCC would have a strong bias for formal action whenever a national bank was experiencing significant problems in areas such as its systems, controls, or internal audit programs — even if the problems had not yet resulted in a change in the bank's CAMEL rating. However, in the absence of these factors, the policy permitted flexibility in applying a wide variety of supervisory and enforcement responses.

During this period, the OCC developed a system to delegate selected enforcement authority to its district offices to more efficiently respond to the increasing number of enforcement cases. Since the mid-1980s, most of the OCC's nonlitigated enforcement actions have been the responsibility of the districts. These actions include the majority of cease and desist orders and formal agreements consented to by national banks and, since 1988, civil money penalties (CMPs) of $10,000 or less. Actions that are the most resource intensive or sensitive continue to be handled by the

Washington headquarters office. These actions include all litigated actions, actions against the most troubled banks, removals, securities actions, complex orders of investigation, temporary cease and desist and suspension actions, and CMPs greater than $10,000.

From 1981 to 1991, the OCC's enforcement actions covered a broad range of areas, including insider lending, lending limits, capital standards, and affiliate transactions. Combatting insider abuse in national banks and holding individuals accountable for their actions were areas especially emphasized by the OCC. Although the vast majority of national banks were free of insider abuse and fraud during this period, the OCC's policy was to tolerate no level of bank fraud or insider abuse in national banks.

The OCC used its punitive enforcement tools, such as CMPs and removals, to respond to any identified instances of insider abuse. Use of punitive enforcement measures served two purposes: to punish those who would harm national banks and to serve as a strong deterrent to others. During this period, the OCC issued removal or prohibition orders against almost 200 individuals. Those engaged in continuing egregious activities also were often immediately and summarily suspended. The OCC also assessed almost 1,500 banks and individuals for various violations of law or abusive practices. Penalties ranged from relatively modest penalties for the filing of late call reports to CMPs in excess of $1 million for serious cases of insider abuse. Total assessments were in excess of $40 million and resulted in settlements or final judgments in excess of $27 million.

Contested Actions

From 1981 through 1991, the OCC took more than 6,000 enforcement actions, including more than 4,400 remedial actions against banks (formal and informal); almost 1,500 civil money penalty actions against banks and individuals; and almost 200 removal actions against individuals. While the vast majority of the OCC's enforcement actions were resolved informally or through stipulation and consent, some were contested administratively, challenged in court, or both. The following actions, most of which resulted in the OCC's positions being fully upheld by the courts, represent some of the most significant enforcement cases involving the OCC during the period:

- *First National Bank of Scotia* v. *Comptroller of the Currency*, 530 F.Supp. 162 (D.D.C. 1982): The court held that it had no jurisdiction to review a cease and desist order issued by the OCC because such review could only take place in the court of appeals. See 12 U.S.C 1818(i)(1).

- *Tirso del Junco* v. *Conover*, 682 F.2d 1338 (9th Cir. 1982), *cert. denied* 459 U.S. 1146 (1983): The court held that the OCC may use its affirmative relief authority in a cease and desist action to require directors to reimburse a bank for losses resulting from violations of the lending limits law. See 12 U.S.C. 1818(b).

- *Eastern National Bank* v. *Comptroller of the Currency*, 786 F.2d 192 (3rd Cir. 1986): The circuit court refused to hear an appeal filed by a national bank involved in an ongoing cease and desist administrative proceeding. The OCC had denied an interlocutory appeal of motion filed in the administrative case; the court refused to intervene, citing the carefully designed statutory scheme of review set forth in 12 U.S.C. 1818. See 12 U.S.C. 1818(b) and (i)(1).

- *Northwest National Bank* v. *Office of the Comptroller of the Currency*, 917 F. 2d 1111 (8th Cir., October 29, 1990): The court affirmed the OCC's cease and desist order against a national bank, finding substantial evidence to support numerous violations of law and regulation and unsafe and unsound practices. The court rejected numerous challenges made by the bank, including an argument that the OCC could not enforce one of its interpretive rulings (which the court found to be a legislative rule and therefore enforceable). The court also rejected arguments that an affiliate relationship did not exist for 12 U.S.C. 371c purposes because the individuals involved did not own "controlling" interest in the entities involved, as well as arguments that the bank was denied due process by not being offered a meaningful opportunity to settle its differences with the OCC prior to the administrative action.

- *First National Bank of Grayson* v. *Conover*, 715 F.2d 237 (6th Cir. 1983): The circuit court held that the district court was correct to dismiss a challenge brought by the First National Bank of Grayson to a suspension imposed by the OCC under 12 U.S.C 1818(g). The court ruled that 12 U.S.C. 1818(i) did not confer jurisdiction on district courts to review such actions and that the plaintiff had failed to exhaust the informal hearing process available from the agency prior to filing suit.

- *John W. Van Dyke, Jr.* v. *Board of Governors of the Federal Reserve System*, 876 F.2d. 1377 (8th Cir. 1989): The court affirmed an action undertaken by the OCC under 12 U.S.C. 1818(e) to remove an individual who was a president and director of a national bank. It also rejected the argument that the "personal dishonesty" standard required by the removal statute had to meet the definition of civil fraud. The court found the Board of Governors' decision upholding the OCC's action and the Board's broader view of fraud (which included factors such a disposition to lie, cheat or defraud; misrepresentation of facts and deliberate deception by pretense and stealth; want of fairness and straightforwardness) to be based on a permissible construction of the statute. Hence the court upheld the Board's definition of fraud applicable to the facts of this case.

- *Greenberg, et al.* v. *OCC, et al.*, (1991 U.S. App. LEXIS 14864)(No. 90-6326, 2nd Cir., June 28, 1991): The court affirmed a district court's dismissal of the appellants' complaint seeking to enjoin the OCC from going forward with administrative enforcement proceedings barring them from further participation in the banking business.

- *Comptroller of the Currency* v. *A. Frederick Greenberg and Richard M. Greenberg*, 927 F. 2d 593 (2d Cir. 1991): The court affirmed and enforced an administrative subpoena issued by the OCC pursuant to its investigative authority under 12 U.S.C. 1818(n) in furtherance of its investigation into defendants' conduct. The court rejected defendants' argument that items allegedly "in the possession of the government" could not be subpoenaed. The court also held that the closure of the bank involved did not affect the OCC's right to subpoena such documents to prepare its administrative enforcement proceedings (removal cases) against the defendants.

- *Abercrombie* v. *Office of the Comptroller of the Currency*, 833 F.2d 672 (7th Cir. 1987): The court affirmed a lower court ruling that a district court lacks jurisdiction to review a notice of assessment of civil money penalty absent any evidence that the Comptroller flagrantly disregarded the law in bringing the [illegible]

- *Abercrombie, et. al* v. *Robert L. Clarke, Comptroller of the Currency*, 920 F. 2d 1351 (7th Cir., December 26, 1990): The court affirmed civil money penalties ranging from $10,000 to $15,000 for violations of an outstanding cease and desist order previously issued against the national bank involved. The court rejected the appellant's argument that the OCC could not assess for past violations of the order. The court found the statutory language in 12 U.S.C. 1818(i) to be ambiguous as to its tense, but concluded the that the OCC's interpretation that the language reached "past" as well as ongoing violations was not unreasonable given the court's review of the language and its legislative history.

- *Central National Bank of Mattoon* v. *United States Department of Treasury*, 912 F.2d 897 (7th Cir., August 29, 1990): The court upheld the OCC's revocation of a bank's trust powers under 12 U.S.C. 92a(k). The OCC revoked the trust powers after the bank displayed a history of violating its trust powers and a serious breach of fiduciary responsibilities occurred when the bank sold trust customers' blue chip holdings to acquire interests in unaffiliated holding company stock in which the bank's president held a controlling interest. Although the administrative law judge who initially heard the case recommended against the revocation of trust powers, the court upheld the Comptroller's decision to revoke, finding the violations to be "substantial" and the remedy clearly within the Comptroller's discretion.

In a small number of cases, the courts reversed or modified OCC enforcement actions during this period. Even in these instances, however, the OCC's actions were ultimately vindicated by Congress in subsequent legislation. The following cases illustrate this point:

- *First National Bank of Bellaire* v. *Comptroller of the Currency*, 697 F.2d 674 (5th Cir. 1983): The court upheld the OCC's cease and desist order in part, but overturned the part of the order directing the bank to increase its capital on grounds that the record did not demonstrate substantial evidence to support the order.

  Following the court's decision in this case, Congress passed the International Lending and Supervision Act of 1983 (ILSA). ILSA provided the OCC with clear authority to set

minimum capital standards for all national banks and to issue capital directives against troubled banks operating with insufficient capital.

- *Larimore* v. *Comptroller of the Currency*, 789 F.2d 1244 (7th Cir. 1986): The court held that the OCC lacked the authority under the affirmative relief provisions of its cease and desist authority to order directors to reimburse a bank for losses resulting from violations of law. The court suggested that *Tirso del Junco* was incorrectly decided and distinguished the case on the grounds that the legislative history supported the conclusion that reimbursement may be proper in cases only involving unjust enrichment. See 12 U.S.C. 1818(b).

  The ambiguity concerning the authority of the OCC and the other federal bank regulatory agencies to order reimbursement was later resolved by Congress in FIRREA, when Congress specifically recognized that a 12 U.S.C. 1818(b) order requiring reimbursement could be appropriate in instances of unjust enrichment or in circumstances evidencing continuing or reckless disregard of the law by directors.

- *Stoddard* v. *Board of Governors of the Federal Reserve System*, 868 F.2d 1308 (D.C. Cir. 1989): The court concluded that the Board of Governors lacked jurisdiction under 12 U.S.C. 1818(e)(1) and (2) to affirm the OCC's removal of a former chairman and chief executive officer of a national bank in that he had resigned his positions prior to being served with a "Notice of Intention to Remove" by the OCC. The court rejected the argument that 12 U.S.C. 1818(e) and 1818(j), when read together, provide the regulatory agency with continuing jurisdiction for removable offenses committed while still an officer or director of the bank involved.

  Under FIRREA, Congress accepted the OCC's position regarding its enforcement authority. This legislation clarified the OCC's and other regulators' authority by affirmatively recognizing agency enforcement jurisdiction over an individual for a period of six years after leaving the institution.

Bank Fraud and Other Criminal Activity

From 1981 to 1991, the OCC significantly increased its efforts to combat bank fraud and other criminal activity in and against national banks. Criminal referrals against individuals associated with national banks steadily increased throughout the 1980s and, in 1991, culminated in an all-time annual high of over 33,000 referrals submitted by national banks and the OCC to the Department of Justice (DOJ). Although the vast majority of these referrals involved fraud of a relatively small amount perpetuated against national banks by outsiders (e.g. credit card fraud) as well as teller defalcations and mysterious disappearances, some also included large-dollar losses caused by bank insiders.

Although the OCC has no authority to prosecute violations of criminal law, it actively worked with the law enforcement community whenever such violations were identified, particularly where bank insiders were involved. The OCC was the first regulatory agency to require that institutions under its jurisdiction submit criminal referrals to the DOJ. Working closely with the DOJ and the other regulatory agencies, the OCC also helped develop a common criminal referral form in 1985. OCC examiners and attorneys also regularly provided information and expertise to support criminal investigations affecting national banks or individuals affiliated with them. During these years a number of OCC examiners also served as agents to the grand jury process. On a number of occasions OCC attorneys also worked on a full-time basis to help investigate and prosecute criminal cases.

Information Sharing

In response to criminal activity taking place in banks, the federal bank and thrift regulatory agencies also took steps to assure that information was shared among the agencies and the DOJ. For example, under the auspices of the Federal Financial Institution Examination Council (FFIEC), the regulatory agencies signed an information sharing agreement in 1984.

The OCC's Enforcement and Compliance Division also developed and maintained the Enforcement & Compliance Information System (ECIS), a computerized database containing critical information on individuals who are the subject of criminal referrals and enforcement actions taken by the OCC and other regulatory agencies. This information has routinely been shared with the DOJ and other agencies for law enforcement purposes.

Training

The OCC's efforts to combat crime in the national banking system also led to the development in the early 1980s of a White Collar Crime School, a course designed primarily for bank examiners. Offered regularly throughout the decade, the course provided

examiners with an overview of the criminal laws applicable to banks and their officers and directors. It also taught investigative techniques to detect fraud in national banks. The FFIEC assumed responsibility for this course in 1986, in order to make the course available to bank examiners from other financial regulatory agencies. Under the auspices of the FFIEC, the OCC helped develop another white collar crime course in 1991 to provide guidance to examiners on how to testify effectively in civil and criminal cases.

The Bank Fraud Working Group

The OCC was also one of the charter members of the Interagency Bank Fraud Enforcement Working Group (BFWG), one of the primary vehicles developed in the 1980s to combat white collar crime affecting insured financial institutions. In December 1984, the BFWG was organized to respond to concerns that prosecutions were failing to keep pace with criminality in financial institutions vulnerable to insider fraud and misconduct. The BFWG's overriding mission was to improve the federal government's response to white collar crime in the nation's federally supervised and regulated financial institutions.

During the 1980s, the OCC contributed to and shared in the accomplishments of the BFWG. Some of the BFWG's most significant accomplishments include:

- *Criminal Referral System* — The BFWG adopted a mandatory criminal referral requirement and uniform criminal referral form under which criminal misconduct is reported directly to U.S. Attorneys and the Federal Bureau of Investigations (FBI).

- *Significant Referral Tracking System* — The significant referral tracking system (SRTS) consists of computerized monitoring of significant criminal bank fraud referrals and reflects the prosecutive response to these referrals. The SRTS is designed to capture selected information contained on the criminal referral form and to provide a periodic status report to supervisory agencies.

- *Legislative Initiatives* — During the mid-1980s, the BFWG sought and obtained amendments to the Right to Financial Privacy Act and the grand jury secrecy rule (Rule 6(e) of the Federal Rules of Criminal Procedure) to [illegible] exchanges of relevant information and to facilitate more complete [illegible] institutions and super[illegible]

- *Communications and Assistance* — The BFWG improved coordination and communication between supervisory agencies and the law enforcement community at the local and national levels. Whenever possible, financial institution regulatory agencies, including the OCC, provided direct assistance and views on plea agreements and sentencing to law enforcement investigators and prosecutors.

- *Fast Track* — The BFWG enhanced cooperation between financial institutions and law enforcement agencies by promoting a "Fast Track" program to aid in the prosecution of small-dollar-loss offenses. These offenses, which increased dramatically in recent years, increased the burden on limited prosecutive and investigative resources. The Fast Track program facilitates prosecution of small-dollar-amount bank fraud and embezzlement cases that previously were considered too small to warrant federal resources.

- *U.S.* v. *Halper* — The BFWG developed a coordinated response to other developments in the law impacting civil and criminal law enforcement, such as *U.S.* v. *Halper*. This decision involved double jeopardy issues as to whether a criminal prosecution could be undertaken following the assessment of a civil money penalty.

- *Model Plea Agreement* — The BFWG produced and distributed to all U.S Attorneys a Model Plea Agreement to standardize the enforcement objectives of the financial institutions supervisory authorities. One provision of the model agreement is a stipulation under which a defendant would agree to be removed from office or prohibited from working in the industry. Another provision contains model language wherein a defendant would agree to pay a civil money penalty or other civil remedy.

- *Bank Bribery Act Guidelines* — The members of the BFWG developed and disseminated uniform guidelines in accordance with the Bank Bribery Act, 18 U.S.C. 215.

Off-Shore Shell Banks

In the 1980s, the OCC also increased its efforts to combat fraud and criminal activity involving offshore shell banks. The OCC's offshore banking unit, the only one of its kind in the U.S. government, was established

to cooperate with local, national, and international law enforcement authorities. The unit helped investigate thousands of advance fee scams, numerous instances of money laundering, and a wide variety of other fraudulent activities. It also assembled a database of information as a source of information to criminal investigators and others. The unit has also alerted the banking industry and the general public to fraudulent practices and criminal activity taking place in offshore banks.

A senior OCC examiner in this unit has become an internationally recognized expert in this area and has provided assistance, including testimony, to international, federal, and local prosecutors in scores of criminal investigations. The examiner has also served as an advisor to governments and an instructor and lecturer on criminal activity in offshore banks.

Enforcement of Securities Law Violations

Although the OCC generally has the same enforcement powers over national banks under the Exchange Act as the Securities and Exchange Commission (SEC) has over public companies, it also has remedies available to it in its capacity as the primary regulator of national banks. The OCC integrates its securities responsibilities into its supervisory activities to enhance the quality of public disclosures made by national banks in securities related filings reviewed by the OCC. When a national bank becomes troubled, the OCC requires full disclosure of the risks of investing in such an institution.

The OCC integrates its banking and securities law enforcement efforts because securities law violations are often closely related to violations of banking law. For example, failure to disclose fraudulent insider transactions can violate line-item disclosure obligations or general anti-fraud provisions of securities laws. In one case, the OCC combined securities and banking enforcement actions into a single action when cease and desist and removal orders were based on misconduct that violated both banking and securities laws.

The OCC has also undertaken separate banking and securities actions in appropriate cases. In 1985, the OCC successfully pursued a removal, civil money penalty, and cease and desist action against a bank based on insider misconduct. In that case the OCC also brought actions in U.S. District Court against the bank and the insider for failing to publicly disclose insider activities.

Through its disclosure review program, the OCC has required national banks to revise offering circulars and to amend disclosures which violate the OCC's securities offerings regulations. When offerings have proceeded in significant noncompliance with these regulations, the OCC has required national banks to offer purchasers an opportunity to rescind purchases or to rescind the entire offering.

Over the last ten years, the OCC has pursued both formal and informal securities enforcement actions. Since 1985, it has taken 24 formal actions, including nine injunction actions and nine actions against bank transfer agents and municipal and government securities dealers.

Enforcement Legislation

The OCC's enforcement powers were significantly expanded by new legislation during this period, especially in the closing years of the decade. Many of these legislative changes were made in direct response to OCC enforcement cases like *Bellaire*, *Stoddard*, and *Larimore* which highlighted the deficiencies in the enforcement statutes.

In 1989, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which greatly expanded the regulatory agencies' enforcement authority. FIRREA did far more than correct statutory defects raised by specific cases. In response to bank regulatory agency concerns, FIRREA expanded the types of individuals who could be the subject of enforcement actions, facilitated the ability of the agencies to take enforcement actions, and strengthened existing enforcement remedies.

To expand the types of individuals subject to enforcement actions, FIRREA authorized bank and thrift regulatory agencies to take actions against "institution-affiliated parties," including officers and directors of banks, as well as other individuals associated with a bank such as attorneys, accountants, and appraisers.

To strengthen existing enforcement authority, FIRREA facilitated the ability of the agencies to take removal actions and enhanced their ability to issue temporary cease and desist orders. In addition, bank and thrift regulatory agencies could now assess CMPs of up to $1 million per day. FIRREA also increased the range of affirmative remedies, such as restitution or restricting asset growth, available to the agencies under a cease and desist order. The ability to remove an individual from banking was also extended to include removal from all federally insured financial institutions.

The agencies' enforcement powers were further expanded by enactment of the Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990 (Crime Control Act) in November 1990. The Crime Control Act greatly expanded the affirmative remedies available through issuance of a temporary cease and

desist order. It also continued the trend toward greater disclosure of enforcement actions. It required that, in addition to all final orders, the agencies make all formal written agreements and enforceable conditions imposed in writing publicly available. The new legislation also required that all administrative hearings be open to the public unless the Comptroller finds that an open hearing is contrary to the public interest. The OCC held its first public hearing under the new law in February 1991, involving an action in which the agency sought a cease and desist order for Truth in Lending Act violations.

In 1990, Congress also strengthened the OCC's enforcement authority for securities law violations involving national banks. The Securities Law Enforcement Remedies Act of 1990 authorized the OCC to assess CMPs and to issue cease and desist orders for violations of certain provisions of the federal securities laws.

Measures to Expedite the Disposition of Troubled National Banks

Assisting Troubled Banks Program

During the years 1981-1991, it became evident that supervisory and enforcement actions to restore a national bank to health would not always succeed. One initiative developed during this period to deal with this reality was a program designed to help recapitalize troubled national banks seeking outside assistance. The Assisting Troubled Banks (ATB) program was not intended to save banks on the verge of failure. Instead, it aimed at assisting institutions while the bank's franchise still had some value. It offered troubled banks expanded recapitalization options, while also offering investors an opportunity to expand into a desired market.

Implemented in 1989, the program introduces potential investors to troubled banks that sought to regain financial stability by seeking outside capital. The voluntary program included expediting the OCC's regulatory review of Change in Bank Control Act (CBCA) notices, which are required when a bank changes ownership. The OCC also expedited its involvement in potential infusions of capital by analyzing financial and other background material submitted by potential investors prior to the formal filing of a CBCA notice.

Insolvency Rule

As the OCC gained experience relating to problem banks, [illegible] found that once a bank's equity capital was [illegible] the bank had virtually no chance of [illegible] without government or outside intervention [illegible] a bank's allowance for [illegible] (ALLL) in measuring bank [illegible] that permit [illegible] owners no longer had any financial interest at stake encouraged imprudent operations, including occasional abuse of high-cost funding sources, and resulted in increased losses. Hence in 1989 the OCC adopted a measure to expedite the closing of national banks whose failure was likely.

The OCC's insolvency rule specified that a national bank's ALLL would no longer be counted when determining the net worth of a national bank. Instead, for purposes of determining solvency, the measure of net worth would be equity capital, i.e., the bank's assets minus its liabilities. The rule permitted the OCC to declare a bank insolvent when its equity capital was exhausted, thereby expediting the closure of an insolvent institution and minimizing the cost to the FDIC's Bank Insurance Fund.

Litigation Relating to Failed National Banks

From 1981 to 1991 issues related to failed banks also resulted in a substantial amount of litigation, some of it involving the OCC. The OCC successfully defended actions challenging its authority to declare national banks insolvent as well as actions claiming that the OCC was liable for negligent supervision of problem banks.

In 1982, a district court ruled in *First National Bank of South Charleston* v. *Conover* that it had no jurisdiction to review the Comptroller's decision on insolvency.

In 1985, the OCC won dismissal of two suits claiming that it was liable directly and indirectly for losses arising from the Penn Square Bank failure. An exemption in the Federal Torts Claims Act for governmental activities which are discretionary, including regulatory activity, formed the basis for both dismissals. This discretionary exception also served as the basis for a ruling by the D.C. Circuit Court of Appeals in 1988. In *Golden Pacific Bancorp* v. *Clarke*, the circuit court affirmed the district court's grant of summary judgment to the OCC in an after-the-fact challenge to the 1986 closing of Golden Pacific National Bank. The court found that the plaintiffs had no claim for monetary damages against the OCC because the closing of the bank fell within the discretionary function exception of the Federal Tort Claims Act.

Two other cases challenged the OCC's authority to declare a bank insolvent, *National Bank of Stewartville* v. *Comptroller*, and *First National Bank of Wilmont, Minn.* v. *OCC*. In both cases the courts upheld the OCC's authority to close insolvent national banks despite bank petitions to delay or prevent the closings

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Legal Developments Involving the Office of the Comptroller of the Currency and the National Banking System, 1981-1991

Adjustable rate mortgages. Discount brokerage. Commingled retirement investment accounts. Securitized assets. Expanded branching authority for national banks. Risk-based capital requirements.

These and other developments affected the national banking system and the Office of the Comptroller of the Currency (OCC) during the years 1981 to 1991. During this time the OCC considered applications for new products and services for national banks, faced numerous legal challenges, implemented new legislation, and released interpretations affecting the structure of the system. On the regulatory front, the OCC implemented risk-based capital requirements for national banks, revised lending limits, and released interpretations to help national banks work through the international debt crisis. This article, while by no means ex- haustive, highlights significant legal issues involving the OCC and the national banking system during the 1980s.

Legal Developments Involving Bank Activities and Services

During the past decade, banks developed a wide range of products and services designed to increase profitability, offer improved services, and respond to technological innovations and greater competition in the financial marketplace. New activities were created, traditional activities were expanded, and, in some cases, existing legal authority was reevaluated and utilized for the first time in a unique way.

Because many new bank activities and services require regulatory review, or permission, prior to being offered to the public, during the 1980s the OCC developed legal opinions interpreting the authority of national banks to offer new products. The OCC also was often called upon to defend court challenges to its interpretations and actions, particularly in cases involving securities-related activities. The agency also participated in initiatives designed to eliminate outmoded restrictions on bank activities and to allow banks to compete with other providers of financial services.

Adjustable Rate Mortgages

During the 1970s, traditional fixed-rate housing finance became burdensome for lenders. Volatile interest rates increased the interest rate risk of traditional fixed-rate housing loans. To enable national banks to continue participating in mortgage financing and to ensure an adequate supply of reasonably priced mortgage credit for consumers, the OCC concluded that national banks must be permitted to price mortgage credit on a flexible basis through adjustable rate mortgages, which enable lenders to share some of the interest rate risk of the loan with the borrower.

The OCC's adjustable rate mortgage regulation, originally published in the *Federal Register* on March 27, 1981, authorized national banks to make and purchase adjustable rate mortgage loans without regard to state law limitations on such loans. The Conference of State Bank Supervisors (CSBS) challenged the OCC's regulatory preemption of state law, but, in a 1983 decision, the D.C. Circuit upheld the regulation.

Over the last decade, the OCC revised this regulation several times to increase flexibility for national banks in pricing mortgage credit. It also expanded the disclosure requirements to enhance the ability of consumers to shop for mortgage credit.

Investment Activities

During the 1980s, national banks greatly expanded their investment-related activities. Responding to incursions from nonbank competitors into bank markets, to a need to diversify into compatible financial services, and to a desire to provide customers with a wide range of services, national banks sought OCC approval to provide their customers with a diverse range of investment services, including discount brokerage, investment advice, annuities, buying and selling futures and options, and entering into swap contracts. The OCC analyzed and approved these activities based on their underlying banking substance — an analysis upheld by the courts in reviewing OCC decisions under the 1933 Glass-Steagall Act.

Discount Brokerage and Investment Advice

After fixed brokerage commission rates were abolished in the mid-1970s, financial services innovators developed discount brokerage services to provide lower priced execution fees for the sale and purchase of stock. Acting on an application filed by Security Pacific National Bank in 1982, the OCC entered this new area when it approved the first national bank discount brokerage operating subsidiary. Although the Secur

ties Industry Association (SIA) filed suit challenging the OCC's approval; the D.C. Circuit, in a 1985 decision supported the OCC's interpretation (*Securities Industry Ass'n v. Conover*). The Supreme Court reviewed a portion of the D.C. Circuit's opinion and in 1987 issued a further ruling on the Security Pacific application: that discount brokerages are not bank branches and thus can be established at non-branch locations.

In addition to discount brokerage services, in the early 1980s banks sought to provide customers new and different products such as investment advisory services. The OCC approved the first operating subsidiary to offer investment advisory services in 1983, ruling on an application filed by American National Bank of Austin, Austin, Texas.

In its initial approvals, the OCC required discount brokerage and investment advice to be conducted in separate corporate entities. However, in 1986, the OCC approved an application for an operating subsidiary of a national bank to provide discount brokerage for institutional investors combined with general economic research obtained from an unrelated research firm. The same year the OCC approved an application for an operating subsidiary to buy and sell options on financial instruments and options on financial futures for retail customers and to provide investment advice.

Once the basic concept of buying and selling securities as agent for customers became familiar, national banks expanded into other investment-related areas, as many new financial products were developed. After OCC legal analysis concluded that national banking laws would not be violated, the OCC approved the following activities for national banks: buying and selling interests in unit investment trusts, mutual funds, and real estate limited partnerships for bank customers; acting as principal in securities transactions with customers; and, building on the long-standing private placement activity of banks, arranging for the private placement of newer financial instruments such as real estate mortgage investment conduit (REMIC) certificates.

Annuities

During the past decade national banks also began offering annuities, another attractive investment option for customers seeking a guaranteed, long-term return on their assets. In several interpretive letters, the OCC permitted national banks to act as agent in the sale of fixed and variable annuities on the basis of the general powers of banks to broker financial investment instruments. In 1991, a federal district court in Texas upheld the OCC's authorization of this activity.

Futures, Options, and Swaps

Another financial service developed in the 1970s and 1980s, buying and selling futures and options, also served as an important risk management device for both national banks and their customers. In 1983, the OCC approved an application to trade in foreign currency options both as principal and as agent for customers. In 1984, the OCC expanded its approval to include acting as a trading exchange specialist and market maker for such options. In 1986, the OCC permitted an applicant to buy and sell, on an agency basis, options on financial instruments such as Treasury bills and Eurodollar certificates of deposit and options on futures on these instruments. In 1989, the OCC approved a national bank request to serve as a principal in these transactions. By 1990, the OCC had authorized buying and selling, on an agency basis, futures and options on all financial and nonfinancial exchange-traded commodities.

The 1980s also saw the growth of financial "swap" contracts of all kinds, which too have become important risk management tools in the financial industry. The OCC approved national banks' engaging in matched commodity price index swaps with customers in 1987 and extended the approval to cover unmatched swaps in 1990.

Asset Securitization

Asset securitization, especially the issuance of mortgage-backed securities, also assumed major importance during the decade of the 1980s. While offering investors an attractive, risk-diversified investment option, national banks were able to remove assets from their balance sheet, freeing up capital which could then be used to support new loans. Initially limited to "pass-through" certificates representing undivided interests in pools of residential mortgages, which the OCC had found to be a permissible banking activity as long ago as 1977, the OCC expanded approval in 1987 to include the issuance and sale of different kinds of mortgage-backed securities known as "collateralized mortgage obligations," or CMOs.

In 1987, the SIA challenged an OCC opinion letter which permitted Security Pacific National Bank to issue and sell mortgage-backed pass-through certificates (*SIA* v. *Clarke*). In 1989, the OCC's approval of this activity was upheld in an opinion by the Second Circuit Court of Appeals. The court's opinion had significant implications for the banking industry because it clarified that banks may continue to conduct banking activities in new securitized forms.

In other actions related to securitized assets, the OCC approved the securitization of loans to investors in limited partnerships in 1987. The following year the OCC permitted a bank to securitize commercial real estate mortgages and installment consumer loans. In 1990, the OCC approved the securitization of credit card receivables.

The farm credit crisis of the mid-1980s led to another development involving securitized assets. When Congress created the Federal Agricultural Mortgage Corporation (Farmer Mac) in 1986 to promote farm lending through the securitization of agricultural loans, the OCC issued a legal opinion allowing national banks to purchase Farmer Mac stock in amounts necessary to participate in the corporation's programs. The OCC also confirmed the authority of national banks to underwrite and deal in securities guaranteed by Farmer Mac.

Commingled Individual Retirement Accounts

In the 1980s, the OCC issued legal advice on the authority of national banks to invest individual retirement account (IRA) trust assets in collective investment trusts. Collective investment of trust funds, often more efficient than separate investment of each individual's IRA funds, allows the fiduciary to provide more investments, carefully selected by the trustee, to a greater number of customers. Although a number of banks registered their collective investment trusts and trust units with the Securities and Exchange Commission, the OCC concluded that Glass-Steagall Act restrictions on securities activities of national banks do not apply to collective investment trusts for IRA accounts because the banks are acting in a *bona fide* fiduciary capacity.

Disagreeing with the OCC's position, the Investment Company Institute (ICI) challenged the OCC in several lawsuits. However, the OCC's position was upheld by separate opinions issued by the D.C., Second, and Ninth Circuit Courts of Appeals. In 1986, the Supreme Court declined to review any of these decisions, thus leaving the circuit court opinions standing.

Other Products and Services

Insurance

The authority of banks to offer insurance was expanded during the decade in an incremental, step-by-step fashion that built on traditional bank activities and prior experience. For example, banks have sold credit life, a type of insurance that pays a loan balance in the event of a borrower's death, for a number of years. Based on this long-standing experience with this type of insurance, the OCC approved an application to underwrite such insurance in 1983.

Title insurance is another type of insurance historically sold by banks. In 1986, the OCC issued a letter permitting national banks to sell title insurance, based in part on the historical origins of this type of insurance which was closely connected with banking. The next year the OCC extended this permission to include underwriting title insurance.

National banks have long had another source of authority for insurance activities, 12 U.S.C. 92, which authorizes national banks located in towns of under 5,000 in population to operate general insurance agencies. Although applications for bank activities under this authority were less frequent due to the geographic limitation, in 1986 the OCC approved an application filed by U.S. National Bank, Portland, Oregon, to sell insurance nationwide from its branch in a small town.*

The OCC often evaluates applications to engage in new insurance activities by applying a functional approach to requests. Thus, it has approved some activities that, although described by others as "insurance," are functionally equivalent to credit or investment products incidental to banking. Two examples of this took place in 1985. In that year the OCC approved the sale of variable annuities, under the bank's securities brokerage authority, although the sale of such annuities is also regulated under state insurance laws. Later that year, the OCC approved the acquisition of a company known as AMBAC to become an operating subsidiary of Citibank. Although AMBAC's product was called "municipal bond insurance," the OCC viewed the activity as a credit enhancement service functionally equivalent to issuing letters of credit. In a 1988 opinion, the D.C. Circuit upheld the OCC's position, determining that municipal bond insurance was the functional equivalent of a permissible standby letter of credit (*American Insurance Association* v. *Clarke*).

The OCC's approach to reviewing these types of applications has led to denials in instances in which certain activities were described in banking terms but, in the OCC's view, were actually insurance not incidental to banking. Thus, the OCC denied a 1984 application to offer "political risk standby letters of credit"

**Although this approval was upheld in National Ass'n of Life Underwriters v. Clarke, the D.C. Court of Appeals ruled on February [illegible] 1992 that 12 U.S.C. 92 was inadvertently repealed by Congress in 1918. However, on June 15, 1992, the Court of Appeals for the Second Circuit, in American Land Title Ass'n v. Clarke, took issue with the D.C. Circuit's conclusion regarding section 92. The U.S. solicitor general is currently considering whether to seek Supreme Court review of these decisions.*

because it viewed the proposed activity as insurance, not a credit program

Real Estate

Real estate lending, which assumed major importance to banks during the decade, also led to significant legal developments on the part of the OCC. Building on the well-established ability of national banks to originate and arrange real estate loans, in 1987 the OCC approved an application of an operating subsidiary to provide commercial real estate loan origination and servicing and brokering of commercial mortgage loans. In so doing, the OCC noted that the origination, buying, and selling of real estate loans as well as the origination, warehousing, and servicing of real estate loans on behalf of other investors are all traditional banking activities.

Since 1990 the OCC has also taken the view that it is legally permissible for a national bank operating subsidiary to provide management services for real estate and other non-loan assets. The assets for which the management services are provided include those acquired by the Resolution Trust Corporation (RTC) from a failed savings and loan association, by the FDIC from a failed bank, or from another depository institution. The OCC's position is based on the traditional authority of banks to provide correspondent banking services to other depository institutions.

Leasing

The Competitive Equality Banking Act of 1987 (CEBA) authorized a national bank to invest in tangible personal property for lease financing transactions up to an amount not to exceed 10 percent of the bank's assets. Thus, "CEBA leases" are not subject to the residual value limitations imposed on traditional bank leasing activity. As a result national banks can rely to a greater extent on the residual value of the leased property in order to recover their full investment. The elimination of the residual value restriction for CEBA leases has enabled national banks to respond to customer demand for a broader range of lease financing transactions and to compete with thrifts and other nonbank lessors, especially for commercial equipment leases.

Legal Developments Involving the Structure of the National Banking System

The past decade saw both the expansion and the contraction of the banking industry. Although more [illegible] failures took place in the decade [illegible] the 1930s, the industry also [illegible] other institutions, [illegible] established new branches, consolidated existing operations, converted from one charter to another, or merged with other institutions. These activities raised numerous issues requiring OCC legal interpretations.

Branching

A far-reaching issue involving national bank branching authority occurred as a result of a 1987 legal decision (*Department of Banking and Consumer Finance of the State of Mississippi* v. *Clarke*), in which the Fifth Circuit Court of Appeals upheld the OCC's determination that Deposit Guaranty National Bank in Jackson, Mississippi, could establish a branch in the same manner as a thrift institution because thrifts in the state of Mississippi were found to be engaged in the "business of banking." Thus, national banks were authorized to establish a branch beyond the 100 mile radius that restricted state-chartered commercial banks in Mississippi. As a result of this decision, similar branch applications were filed across the country by national banks seeking the same branching authority as state-chartered thrifts within their state. The OCC has approved a number of these applications since 1987; in cases in which approvals have been challenged in court, the OCC's position has been upheld.

Another development relating to bank expansion in the 1980s involved automated teller machines. Throughout the decade, the OCC supported, within statutory constraints, national banks' efforts to expand their use. In a 1985 court decision involving branching (*Independent Bankers Association of New York, Inc.* v. *Marine Midland Bank, N.A.*), the Second Circuit upheld the OCC's position that a shared terminal in a grocery store was not a national bank branch. This determination permitted bank customers to gain access to their accounts outside of the geographic branching limits of their bank.

In a 1986 decision involving geographic constraints on national bank activities (*McEnteer* v. *Clarke*), a federal district court in Pennsylvania approved the Comptroller's ruling that a national bank can relocate its main office within 30 miles of the city in which the bank is located, even if the location is in another state. This ruling, the first to uphold the OCC's approval of a main office relocation across state lines, was important because it allowed national banks to provide better services to customers living near state boundaries.

Nonbank Banks

One innovative corporate development occurring in the past decade was the nonbank bank, an institution chartered as a national bank which either did not accept deposits or did not make commercial loans and

consequently was not a "bank" within the meaning of the Bank Holding Company Act. The nonbank bank was designed to avoid geographic and other competitive constraints which prevented banking and other institutions from offering financial services to consumers. An important decision relating to nonbank banks occurred in 1984 when the OCC approved the application of Dimension Financial Corporation for 31 banks in 25 states. The OCC subsequently considered 330 other nonbank bank applications, requiring analysis of the laws of 39 states and numerous other issues.

In a 1986 decision, the Supreme Court denied the Federal Reserve Board's authority to include nonbank banks within the scope of the Bank Holding Company Act, however, in 1987 Congress effectively ended the nonbank bank phenomenon by redefining "bank" as it had appeared in the Bank Holding Company Act to include all FDIC-insured depository institutions. However, Congress permitted some grandfathered nonbank banks to continue in operation and permitted certain other non-full service banks to operate outside the scope of the Bank Holding Company Act, including credit card banks.

Mergers

During the past decade, the OCC's approval of merger applications was the subject of court challenges based on antitrust and other grounds. Continuing a line of successes dating from the early 1970s, the OCC generally prevailed in these cases. For example, in a 1982 case, *U.S.* v. *Virginia National Bankshares*, a district court upheld the OCC's service area merger analysis against a Department of Justice antitrust challenge. In a 1987 case, *Washington, et al.* v. *OCC*, a district court upheld the OCC's approval of the merger of First Union Bank of Savannah with First Union National Bank of Georgia against a challenge based on the Administrative Procedure Act and the Community Reinvestment Act filed by a local reinvestment group.

Stock Appraisals/Reverse Stock Splits

The past 10 years also saw an increase in the number of cases challenging the OCC's stock appraisal procedures. These cases questioned both the OCC's methodology and the results of the Comptroller's appraisal of dissenting shareholders' stock. In a 1983 case, *Martin* v. *Kilgore First Bancorp., Inc., et al.*, the OCC filed an amicus brief which was adopted as the position of the district court. The court held that, in a reorganization involving a bank's change to holding company ownership, it was proper for the holding company shares, and not the interim bank shares, to be auctioned. In 1984, the Fifth Circuit upheld the Comptroller's interpretation in this case. In a 1985 case, *Beerly* v. *Department of the Treasury*, the Seventh Circuit upheld the method by which the OCC appraises the stock of dissenting shareholders. The OCC's appraisal of dissenting shareholders' stock was upheld in 1986 by the Third Circuit in *Keeffe* v. *Citizens and Northern Bank, et al.*

In 1990, two appellate court decisions overturned the OCC's approval of corporate transactions affecting minority shareholders. In *Lewis* v. *Clark [sic]*, the United States Court of Appeals for the Eleventh Circuit held that the OCC has no authority to approve a merger in which minority shareholders of a target bank are required, over their objection, to take cash for their shares in the disappearing bank while the majority shareholders of the target bank are permitted to receive stock. In another case, the United States Court of Appeals for the Seventh Circuit upheld a decision of a lower federal court that a reverse stock split the freezes out minority shareholders was impermissible (*Bloomington National Bank* v. *Telfer.*

Thrift Conversions and Acquisitions

During the latter years of the decade, the structure of the national banking system also changed as state and federally chartered thrifts entered the national banking system through conversion or acquisition. When Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), it permitted conversions so long as the resulting institution remained insured by the Savings Association Insurance Fund (SAIF). After FIRREA national banks also began acquiring thrifts offered for sale by the Resolution Trust Corporation (RTC), the agency created to dispose of the assets of insolvent savings and loans. This new authority allowed national banks to either convert the failed thrift's deposits to Bank Insurance Fund (BIF) insurance or acquire the thrift's deposits but keep them SAIF-insured. National banks also acquired healthy thrifts and branches of healthy thrifts under statutory provisions which permit some SAIF-insured thrift deposits to be converted to BIF-insured bank deposits.

Legal Developments Involving Supervisory Issues

Lending Limits

During the last ten years, the OCC developed a number of significant regulations and legal opinions interpreting the national bank lending limit, the statutory limit on the amount of credit that a national bank is permitted to extend to any one borrower. After enactment of FIRREA, the OCC also helped the Office of Thrift Supervision (OTS) to implement the provision in FIRREA which generally made thrift institutions subject to the same

limits on loans to one borrower as those applying to national banks.

A new regulation, 12 CFR 32, probably represents the most noteworthy development concerning lending limits during the past decade. Implementing amendments in the Garn-St Germain Act of 1982, the regulation raised the general lending limit from 10 to 15 percent, added a new secondary limit permitting banks to expand their lending by another 10 percent for loans secured by readily marketable collateral, and consolidated and modified some of the statutory lending limit exceptions. It also empowered the OCC to prescribe rules and regulations to administer the newly amended statute and to define when a loan made to one person should be attributed to another.

The new lending limit regulation, which prompted over 200 comments when it was proposed, incorporated changes specifically mandated by statute; it also set forth rules developed by the OCC defining when loans to separate entities must be combined for lending limit purposes. Since 1984, when 12 CFR 32 was published, hundreds of letters have been issued, explaining and interpreting the new regulation.

Part 32 has been modified several times over the past several years. In 1986, the OCC published a temporary substitute lending limit regulation to complement a capital forbearance program, which Congress had urged the banking regulatory agencies to adopt to provide temporary relief to banks suffering a decline in capital because of problems in the agricultural, oil, and gas industries. The temporary regulation created a special lending limit for national banks with charged off agricultural, oil, and gas loans; it was later finalized and subsequently extended from January 1, 1993, to January 1, 1995.

Later in 1988, the OCC published another temporary regulation to provide an immediate solution to the dilemma confronting banks that had entered into loan commitments but then experienced a decline in their capital, and hence, in their lending limits. The temporary rule, finalized in 1991, permits banks to treat a loan commitment either as a loan which can be funded during its entire term or as a loan commitment where only funds advanced need be added to the bank's lending limit calculation. Other significant regulations and interpretations have dealt with the treatment for lending limit purposes of restructured foreign sovereign debt.

Capital

The years [illegible] saw fundamental changes in [illegible] national banks. Prior to 1983, [illegible] bank supervisory agencies monitored capital adequacy through policy statements and guidelines. After enactment of the International Lending Supervision Act of 1983 (ILSA) however, the federal banking agencies established minimum capital requirements for banking institutions. In 1985, the OCC established minimum capital ratios for national banks based on the total assets of the institution.

As the decade progressed, banking regulators in the United States and elsewhere also began developing a system of risk-based capital which is based on the riskiness of the portfolio of a bank. Risk-based capital reflects the concept that banks engaging in riskier activities should hold more capital than those engaging in safer activities. In July 1988 the Basle Committee on Banking Regulations and Supervisory Practices adopted an international agreement on risk-based capital (Basle Agreement). The Basle Agreement represented the culmination of several years of effort by the U.S. bank supervisory agencies and their international counterparts to develop internationally uniform capital standards.

The OCC implemented the Basle Agreement through its risk-based capital guidelines, which became effective on December 31, 1990. In conjunction with the risk-based capital guidelines, the OCC amended the minimum capital requirement to provide for a leverage capital ratio to ensure that even banks with a relatively riskless portfolio maintain a certain minimum level of capital.

International Banking

In the early years of the decade, national and other banks experienced problems as certain less developed countries (LDCs) had difficulty servicing their debt. In addition to developing supervisory strategies to deal with these nonperforming assets, the OCC considered innovative programs designed to reduce the burden on national bank balance sheets.

Debt-equity swaps were one technique developed. The technique allows LDC debt to be "swapped" for equity in private sector corporations in the debtor country. The swaps involved the use of a national bank's authority to take property in satisfaction of debts previously contracted (DPC). These foreign debt restructurings benefited both the debtor and the bank by advancing the major goals of debt management: improved economic performance for the country and reduced exposure of the bank. Beginning in 1987, the OCC issued a number of opinions on such swaps, involving debt of Mexico, Brazil, Venezuela, Chile, Argentina, and Honduras.

The refunding of outstanding debt, either in conjunction with a debt-equity swap or alone, was another debt

management technique developed during the decade. OCC letters in 1988 and 1989 dealt with the refunding of Mexican and Brazilian debt.

During the years 1981 to 1991, the OCC also provided technical guidance to the Department of the Treasury on bilateral and multilateral trade negotiations. Through these agreements the United States has attempted to open foreign markets to U.S. financial services providers, including firms engaged in banking, securities, and insurance. For example, an OCC representative attended the negotiations of the United States-Canada Free Trade Agreement, which the president signed in 1988. Since 1989, the OCC has also provided technical assistance to the Treasury Department for the multilateral negotiations on financial services currently being conducted as part of the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) talks.

This article was prepared under the direction of Barrett Aldemeyer of the Law Department. Other contributors included Kay E. Bondehagen, Joyce B. Dixon, Jerome Edelstein, John Ference, Harold J. Hansen, Caren S. Hersh, Deborah Katz, Elizabeth Kirby, Rosa M. Koppel, Peter C. Liebesman, Christopher Manthey, Ferne Rubin, Jonathan Rushdoony, and Ronald Shimabukuro.

Selected Speeches and Testimony Presented on Behalf of the Office of the Comptroller of the Currency, 1981-1991

Page

Selections related to the supervision of the national banking system:

Selections related to key developments affecting the national banking system:

Page

Statement of John G. Heimann, Comptroller of the Currency, before the Senate Committee on Banking, Housing, and Urban Affairs, on issues facing the financial services industry in the 1980s and on recommendations for reform, Washington, D.C., April 28, 1981

Mr. Chairman and members of the committee, we appreciate this opportunity to discuss competitive and economic conditions within the financial services industry and to review major banking laws.

We are all aware of the fundamental forces reshaping the financial services industry in our country and abroad: inflation and economic uncertainty, erosion of geographic barriers to competition, erosion of product market barriers, deregulation of the liability side of the balance sheet, revolution in technology, demographic shifts and, finally, government's role.

In the face of such change, we must step back, analyze what is happening and where things appear headed, assess whether existing policies, regulations, and laws are appropriate and revise policies, regulations, and laws to guide the financial system through that period of change and at the same time strengthen the vitality and increase the flexibility of the system and the economy. The condition of the financial system in the coming decade will reflect not only the forces of the marketplace, but, of equal importance, decisions made in the public sector by Congress and regulatory authorities. It will also reflect our success in moderating inflation and restoring economic stability.

These hearings, because of their broad approach, are a valuable beginning in shaping the agenda of issues and topics for comprehensive review and, over the longer term, in reshaping the statutory and regulatory framework within which the financial system operates. In our view, no part of that framework should be exempt from scrutiny, including the structure of the financial institutions' regulatory agencies.

In the past, these hearings focused on the commercial banking system, and our testimony tended to center around national banks. However, the many changes taking place make it more appropriate now to speak of the entire financial system, that is, the financial services industry, domestic and international. Therefore, in discussing the agenda for review, it is useful to place national banks, commercial banks, and deposit-taking institutions in the context of the financial services system.

U.S. Financial System

Our financial system is a myriad of different types of institutions. Financial services are provided by traditional depository institutions—commercial banks, savings and loan associations, mutual savings banks, and credit unions—and mortgage bankers, finance companies, federally sponsored credit agencies, insurance companies, pension funds, investment bankers, securities brokers, real estate service firms, and even the financial activities of retailers and other nonfinancial businesses.

At year-end 1980, financial institutions held over $4 trillion in domestic financial assets. Over 42,000 depository institutions accounted for $2.4 trillion (59 percent). Domestically chartered commercial banks, with 14,630 reporting at year-end, held the largest amount, $1.5 trillion (38 percent). There were 4,425 national banks at year-end (30 percent of the total number of commercial banks) holding 57 percent of total domestic bank assets.

The 4,600 savings and loan associations were second with approximately $630 billion in assets (15 percent). The 463 mutual savings banks and 22,000 credit unions held 4 percent and 2 percent, respectively. Life insurance companies, with $456 billion in assets (11 percent), made up the largest segment of the nondepository financial industry, followed by private pension funds with $265 billion in assets (7 percent).

Historically, financial institutions have tended to fill specific roles, each industry offering a different product to its customers. For instance, in terms of credit offered to borrowers, each depository institution has had its specialty, e.g., commercial loans for banks, residential mortgage loans for thrift institutions and consumer loans for credit unions. Frequently such specialization has been reinforced by legislation narrowly defining permissible product lines. For example, savings and loans are legally barred from making commercial loans.

While the distinctions between banks and thrifts and between depository and nondepository institutions used to be clear, such institutional differences are disappearing. Different types of financial institutions increasingly offer similar products and services and compete in the same markets. In particular, institutions which do not call themselves banks and which are not equally defined as banks are engaging in a variety of activities traditionally associated with banking. While many of the financial institutions may be virtually indistinguishable from the perspective of a customer, sig-

nificant differences still remain in terms of regulatory and legal status

To take an obvious example, consumers are no longer limited to commercial banks for transaction account services—now they may go to a local thrift institution or credit union, or to an investment banker or insurance company sponsoring a money market mutual fund (MMF). As of mid-April, MMF's held $116 billion in shareholder accounts, yielding over 14 percent. Merrill Lynch alone holds approximately $23.5 billion of assets in its three money market funds. By comparison, commercial banks have approximately $42 billion in negotiable order of withdrawal and automatic transfer service accounts, subject to a federally imposed deposit rate ceiling of 5¼ percent.

More importantly, the pace of change in the financial system appears to be accelerating. Last year, the RCA, a diversified communications and electronics concern, paid $1.35 billion for C.I.T. Financial Corporation, one of the country's largest financial services companies with activities in insurance and installment financing. The recent acquisition of Bache Group by Prudential Insurance Co. and the proposed acquisition of Shearson Loeb Rhoades by American Express create two more major multifaceted financial institutions capable of providing a wide range of financial services, including insurance, investment, credit cards, and other bank-like services.

Clearly, old distinctions among the providers of financial services are blurring, and competition is increasing. That is a natural result of changing marketplace realities and is beneficial to consumers and businesses and to the economy and the country. Yet, the framework of laws and regulations that define the boundaries within which different types of financial institutions are allowed to operate is uneven, giving unintended advantage to some institutions over others. In particular, antiquated, inappropriate, and inefficient laws and regulations substantially impede the ability of depository institutions to compete with other providers of financial services. Although it is possible that we can continue muddling along, we are convinced that failure to address the problems posed by the existing legal and regulatory framework will threaten the long-run strength and vitality of the commercial banking system—indeed all deposit-taking institutions.

Performance of Commercial Banks and Thrifts

Before discussing the issues and topics that we believe should be included on the agenda for comprehensive review, it is useful to discuss the recent performance of commercial banks and thrift institutions and to comment on the changes financial institutions will have to adjust to in coming years.

Events during 1980 were unsettling for the country, the economy, financial markets, and financial institutions. The prime rate rose from 13.25 to 20 percent, fell to 11 percent and then rose again to 21.5. Although a program of credit restraint was imposed and a short recession occurred early in the year, inflation continues unabated. In addition, Congress passed legislation providing for significant deregulation of activities of deposit-taking institutions.

Commercial Bank Performance—Commercial banks weathered those events unexpectedly well as indicated by their performance in terms of asset growth, earnings, asset quality, liquidity, and capital.

Asset Growth—The combined effect of a sluggish economy and the credit restraint program in effect during early 1980 resulted in the slowest growth in assets at insured commercial banks since 1976. The 9.7 percent increase in total domestic and foreign assets to $1.856 billion last year contrasts with growth rates that ranged from 12.2 to 13.3 percent in the three preceding years.

Growth of Insured Commercial Bank Assets and Equity ($ billions)

	Total assets	Annual percent change	Equity capital	Annual percent change	Equity/ assets (percent)
1970	$ 616	10.9	$ 40.5	7.8	6.58
1975	1,095	4.7	64.3	8.8	5.87
1976	1,182	7.9	72.3	N/A*	6.11
1977	1,339	13.3	79.3	9.7	5.92
1978	1,508	12.6	87.4	10.3	5.80
1979	1,692	12.2	97.2	11.2	5.75
1980	1,856	9.7	107.6	10.6	5.80

*Definition of equity capital altered in 1976, numbers before 1976 are not strictly comparable with those after 1975.

The relatively slow growth in bank assets was related to a sharp reduction in loan demand. Loans outstanding at insured commercial banks increased only 7.4 percent and more than one-third of that increase resulted from loans booked at foreign offices. Foreign office assets at all insured commercial banks increased 10.9 percent to $323 billion as compared to the 9.4 percent increase in domestic assets. That was a sharp break from the experience of the prior four years, how-

ever, when foreign office growth averaged over 19 percent and peaked in 1979 at nearly 22 percent.

Earnings—Insured commercial bank earnings continued to increase in 1980, although the rate of growth declined from 1978 and 1979. Despite increasing reliance on market rate funds, particularly 6-month money market certificates, commercial banks generally maintained their interest rate margins, and the return on assets for the banking system declined only slightly to 0.79 percent of assets from 0.80 in 1979.

Net Income of Insured Commercial Banks
($ billions)

	Net income	Annual percent increases	Net income/ average* assets (percent)	Net income/ average* equity (percent
1970	$ 4.837	11.6	0.83	12.4
1975	7.255	2.3	0.68	11.8
1976	7.843	8.6	0.69	11.5
1977	8.879	13.2	0.70	11.7
1978	10.760	21.2	0.76	12.9
1979	12.838	19.3	0.80	13.9
1980	14.010	9.1	0.79	13 7

*Averages are of preceding and current Decembers.

While larger commercial banks have extensive experience in funding a large part of their operations with market rate funds, the rapid growth of money market certificates from \$106 to \$178 billion in 1980 and the resulting increased sensitivity of the cost of funds to changes in market rates meant that banks of all sizes had to make adjustments in pricing and operating policies.

The ability of smaller banks to adjust their traditional operating and pricing policies rapidly in light of the economic volatility and the increased sensitivity of their cost of funds to market rates provided dramatic evidence of their flexibility and adaptability. The 12,735 insured commercial banks with assets of under \$100 million increased their return on assets from 1.09 percent in 1979 to 1.12 percent in 1980. That continued a generally upward trend that has lasted for more than a decade. Their return on equity was 13.28 percent, a slight improvement over 1979.

Earnings performance at the larger banks did not show a clear gain over their very successful performance in 1979. Return on assets declined by two basis points to 0.78 percent for the 1,682 insured commercial banks with assets between \$100 million and \$10 billion. Similarly, the return on equity dropped from nearly 13 to 12.50 percent. The pressure on earnings and equity was felt most strongly by regional banks, generally those with assets between \$1 billion and \$10 billion.

The 18 largest banks with assets over \$10 billion and with extensive international operations achieved virtually the same return on assets (0.54 percent) and on equity (13.77 percent) as in 1979.

Asset Quality—Some deterioration in asset quality was apparent in 1980 resulting from the economic downturn and the difficulties of some businesses and individuals in adjusting to higher borrowing costs. Net loan losses for the year rose to \$3.6 billion from \$2.6 billion the previous year. National banks reported that 4.2 percent of their domestic loans had overdue payments at year-end, the highest ratio reported for December since 1976. Commercial banks increased their reserves for potential loan losses out of earnings to an extent that more than offset the increase in actual losses and raised their reserves to 1 percent of outstanding loans.

Insured Commercial Bank Loan Losses and
Loan Loss Reserves
(billions)

	Net loan losses	Allowance for possible loan losses	Allowance/ total loans (percent)
1970	$ 0.981	N/A	N/A
1975	3.243	N/A	N/A
1976	3.503	$ 6.348	1.01
1977	2.797	6.894	0.95
1978	2.497	7.957	0.96
1979	2.564	9.183	0.98
1980	3.598	10.053	1.00

National Banks Domestic Office Loans Past Due
($ billion)

	Amount past due	Percent past due
1975	$14.7	5.0
1976	13.0	4 2
1977	13.0	3.7
1978	14.7	3.6
1979	18.2	4 0
1980	20.1	4 2

Traditionally, the loan-to-deposit ratio reflected liquidity When that ratio was high, a bank generally had less cash and marketable securities to meet liquidity needs

That ratio is no longer a very good indicator of liquidity because it does not measure a bank's ability to purchase funds in the marketplace. Dependence on purchased funds can enhance liquidity, but it can lead to rapid loss of liquidity if the market loses confidence in an institution. There are also other indicators of potential liquidity risks such as asset and liability maturities, interest rate margin and loan commitments.

Liquidity—Based on the traditional measure of the ratio of loans to deposits, liquidity of commercial banks improved slightly in 1980. That resulted from the slow growth in loans relative to deposit growth. For small banks, the loan-to-deposit ratio dropped to 59.5 percent at year-end, compared with 63 percent in 1979. For the largest banks, however, that ratio continued to increase, as it has for most of the last decade, reaching 74.8 percent at year-end 1980.

A better measure of risks to liquidity is the ratio of purchased funds to assets, which indicates the dependence of a bank on purchased funds. Growth in money market certificates, large time deposits, foreign office deposits, federal funds transactions and borrowed money resulted in banks holding short-term, high interest-bearing liabilities equal to nearly 50 percent of their total assets at year-end.

Insured Commercial Bank Liquidity
and Purchased Funds
($ billions)

	Loans/ deposits (percent)	Purchased funds* assets (percent)
1970	60.5	10.6
1975	64.0	32.4
1976	63.2	32.3
1977	64.7	33.5
1978	67.4	37.9
1979	68.5	43.9
1980	67.7	48.7

*Foreign office deposits, federal funds transactions, borrowed money including Treasury notes, large certificates of deposit, other time deposits over $100 million, and 6 month money market certificates.

Although the larger banks continued relying more heavily on purchased funds than the smaller ones, the advent of money market certificates in 1978 has resulted in a tremendous increase in market rate funds at smaller banks. At year-end 1978 insured commercial banks with assets under $100 million held purchased funds equal to 12.5 percent of their assets. By year-end 1980, that ratio had jumped to 21.4 percent, with most of the increase accounted for by money market certificates. At the largest multinational banks, the ratio of purchased funds to total assets rose from 59.8 to 64.2 percent in the same period. Reliance on purchased funds has increased tremendously for all banks over the past decade, reflecting problems created by deposit interest rate ceilings and changes in the economy, especially inflation and high interest rates. That trend seems likely to continue for the foreseeable future.

Capital—The slow growth rate in bank assets in 1980 caused the equity-to-asset ratio for insured commercial banks to increase for the first time since 1976 despite a sharp drop in new capital issues. The ratio was 5.80 percent in 1980 compared with 5.75 in 1979 and 6.11 in 1976.

The average equity-to-asset ratio for banks with under $100 million in total assets rose to 8.46 percent from 8.21 in 1979 and 7.94 in 1976, continuing a long-term trend of increases. For banks with assets above $10 billion, the 3-year decline in capital ratios halted in 1980 as the equity-to-assets ratio rose to 3.93 percent from the previous year's 3.90. That ratio was not much different from the 4.03 percent level for 1975, although substantially less than the 5.09 percent level for 1970.

Banks Under Special Supervision and Bank Failures—The number of national banks characterized by the uniform financial institutions rating system as having "financial, operational or managerial weaknesses so severe as to pose a serious threat to continued financial viability" increased to 51 at year-end 1980, compared with 49 for 1979. Those 51 banks accounted for 1.2 percent of all national banks and held only 0.8 percent of the assets of all national banks.

There was continued improvement for banks which do not have a strong possibility of failure or insolvency but still warrant some supervisory concern. The number of those banks dropped from 217 in 1979 to 206 in 1980. One small national bank failed in 1980. Additionally, one national bank was merged to avert failure.

Those indicators reflect an industry which, on balance, continues to demonstrate a high degree of financial health and stability. Although costs associated with negotiable order of withdrawal accounts and with pricing of Federal Reserve services and loan losses stemming from the 1980 recession may place downward pressure on commercial bank earnings this year, we believe that commercial banks have the capability to continue adjusting successfully to the changing and more volatile economic environment. However, longer term prospects are less encouraging unless competitive and other restrictions that now hamstring the

flexibility of those institutions are eliminated or modified appropriately.

Thrift Performance—Inflation and high and volatile interest rates have had devastating effects on financial institutions, predominantly thrift institutions, whose asset portfolios are primarily long-term, fixed rate mortgages. During most of the post-World War II period, the mismatched asset-liability maturity structure of thrifts has worked relatively well. However, given the current volatile interest rate environment with short-term rates frequently exceeding long-term rates and the dramatic upward shift in the cost of funds caused by the increased interest sensitivity of depositors, the profitability of such an asset-liability maturity structure has been seriously impaired. Thus, many have concluded that continued origination and holding of (30-year) fixed rate mortgages—even at today's high rates—is imprudent. Those effects have been amplified by deposit rate deregulation, which began with the introduction of the money market certificate of deposit in 1978 and which, under the provisions of the Depository Institutions Deregulation Act, will result in total elimination of controls by March 31,1986. Rate deregulation, of course, became imperative when inflation-induced high interest rates led to outflows of deposits into unregulated market-rate instruments and created concerns about providing small savers with the opportunity to realize market rates.

The net annual after-tax income-to-asset ratio of savings and loan associations has decreased sharply over the past two years, falling from 0.83 percent in the second half of 1978 to 0.10 percent of assets in the second half of 1980, according to Federal Home Loan Bank Board statistics. The cause of that decline in earnings is evident: The average cost of funds for insured savings and loans in the last two years rose 2.32 percentage points to a record annual rate of 9.11 percent in the second half of 1980, while the return on mortgage portfolios of insured savings and loans rose less than 1 percentage point to 9.44 percent. Approximately 50 percent of all savings and loan deposits are now in the form of certificates not subject to ceilings or with ceilings tied to market rates.

It should be recognized that for many thrift institutions the problem is not primarily of their own making. By law they have been required to provide financing or housing. That has resulted in asset portfolios dominated by long-term mortgages. Moreover, until recently, public and regulatory policy has favored the fixed rate mortgage and has retarded the development of adjustable rate and other alternative mortgage instruments.

Last year thrifts were given new asset powers that will enable them to diversify their portfolios and shorten maturities. Moreover, regulatory policy has been adjusted to permit a variety of alternative mortgage instruments. More may be required, however, such as additional asset powers to assure the viability of thrift institutions over the longer term.

Most thrifts are well-managed and, given time, will once again be profitable, aggressive competitors. But as long as interest rates remain at or near the present high levels, time will be required to make adjustments. For example, at year-end 1980, over two-thirds of the savings and loans' mortgage portfolios still had long-term, fixed rate loans with contract interest rates of less than 10 percent. It would be a tragedy for those institutions, the financial system and the country if what amounts to a short-run problem that can be solved over a period of time were permitted to control events. Until the problem of those below market-rate mortgages is solved, however, it will impede progress in deposit deregulation and prevent depository institutions from becoming competitive with other providers of deposit-like services.

Shaping of the Financial System in Coming Years

While much of the financial system, with notable exceptions, has already made substantial progress in adjusting to changed circumstances, basic forces continue to reshape the societal, economic, and business environments of banks and other financial institutions.

One force is economic uncertainty. Inflation, volatility in interest rates, and fluctuations in unemployment and production have heightened uncertainty and made the business of providing financial services much more difficult and risky. Hopefully, progress will be made in solving those problems, but prudence dictates that we should be prepared for continued economic uncertainty, expecting the unexpected. Given time and regulatory flexibility, most institutions can adjust portfolios and operating policies and procedures to respond to economic volatility and high interest rates in ways that will maintain their viability and enable them to thrive.

Over the long run, depository institutions will be able to reduce asset maturities by diversifying into shorter maturity assets or by adopting flexible pricing on longer maturity assets. Another approach is to continue originating and servicing long-term assets but to sell them to institutions better able to manage interest rate risk. Brokering of assets is already occurring through mortgage pass-through certificates and similar programs and conceivably could be extended to consumer and commercial loans. Brokering activities by depository institutions have been limited, partly because of the difficulty of pooling and selling loans in the capital markets.

A second force reshaping the environment for financial institutions is the increasing use of more sophisticated technology in delivering financial services. Indeed, use of innovative technology in providing financial services may be on the verge of rapid implementation.

Inflation and technology are important catalysts in eroding barriers to competition that have traditionally separated banks and thrift institutions from other financial institutions. Technological developments enhance the potential for depository and nondepository institutions to expand markets, regardless of price controls and statutory limitations on products and office locations. The capacity of large financial organizations to offer services on a mass marketing basis over a wide geographic area will expand greatly. And, either directly or through third party vendors, correspondent banks, bankers' banks or sharing arrangements, smaller institutions will also offer automated services profitably and at competitive prices.

A third factor affecting the financial environment is demographic and labor force changes. In the 1980s, members of the post-war baby boom generation will mature. There will be more workers in the prime age category of 25 to 44 and fewer young people. The work force will be better educated, more stable, and more productive. Moreover, many predict continued migration from the North and East to the South and West. Such demographic shifts will have important implications for financial product markets.

A fourth factor is government. For better or worse, decisions made in the public sector—whether pertaining to geographic restraints on competition, monetary policy, consumer protection, or capital adequacy—profoundly affect how the private sector conducts business. It seems, ironically, that although we are all committed to the concept of deregulation, law and regulation have become more, not less, pervasive in recent years.

All those factors point toward an obvious conclusion: The business of providing financial services will not only be different in the 1980s but significantly more difficult and challenging. It will be uncertain, more complex, intensely competitive, and will involve far greater potential for error.

For those reasons, we believe that not only should we review the existing framework of law and regulation governing the financial system, but we should do so seriously and move as expeditiously as possible to design a new framework responsive to the world of [illegible]. The agenda is large and comprehensive [illegible] competitive issues, consumer protection issues, and structure of the regulatory system itself.

Competitive Issues

A significant part of the agenda of issues and topics for comprehensive review relates to the laws and rules which define and restrain competition among providers of financial services. There are three issues in that area: deposit deregulation, geographic restrictions, and laws and regulations limiting products and services that commercial banks and other depository institutions can provide.

Each of those three issues stands at a different stage in the public decisionmaking process, presenting a different kind of challenge:

- Deposit deregulation, debated for a decade or more, apparently was resolved by the 1980 Depository Institutions Deregulation and Monetary Control Act. The challenge is sticking to the mandate of that act and implementing deregulation.

- Geographic restrictions have been debated frequently, if not always rationally, and in many respects, the effectiveness of such restrictions is diminishing in the marketplace. While the road map for deregulation is rather clear, the challenge is deciding to deregulate and move ahead.

- Glass-Steagall and other product segmenting restrictions have not yet been debated as fully as the other issues, and evolution in the marketplace has not progressed as far. Moreover, the road map for change is not clear. The challenge now is to examine and debate that issue thoroughly.

Because change creates uncertainty and threatens long-established practices, the temptation to resist it is understandable. History has not been kind, however, to those who ignored currents of change or tried to control them. Energies spent on maintaining protections could be devoted more productively to designing ways of adjusting to change. Apart from creating delay, attempts to stem the tide of developments that are inexorably eroding the remaining effectiveness of limitations on competition will be futile. Delay will harm the overall competitiveness of the financial system, particularly segments that are more heavily regulated.

Deposit Deregulation—From the time of the Hunt Commission until the passage last year of the Depository

Institutions Deregulation and Monetary Control Act, the issue of deposit deregulation stood at center stage of political and public policy debates on financial institutions. Enactment of that legislation marked a resolution—at least temporarily—of the fundamental policy question. Now the question is "how," not "whether," to end federal regulation of the prices and types of deposit products and services.

The choice of a deregulation strategy is difficult, as reflected in the actions of the Depository Institutions Deregulation Committee (DIDC) during the past year. Though specific DIDC actions might be questioned for appropriateness or wisdom, they reflect the committee's sincere attempts to balance the complicated and sometimes inconsistent missions assigned to it by Congress.

Many depository institutions have expressed concern to the committee recently about the competitive threat posed by money market funds. Suggestions and petitions have been advanced to provide depository institutions with deposit tools to compete with the money market funds or, in the alternative, to place restraints on the funds themselves. That matter underscores the difficult task facing the committee in coming months and the relationship of that task to the fundamental questions involving the structure of the financial services industry.

Our preferred answer to the money market fund issue is to grant depository institutions the flexibility necessary to compete with the funds on an equal footing. That solution, however, would be difficult to implement because of the poor earnings posture of some depository institutions, especially thrift institutions.

What about restraints on money market funds? We would be unhappy to see effort in that direction. On a philosophical level, that would represent new government intrusion, precisely the wrong signal at this time. Whatever form new regulation were to take, it would ultimately be ineffective because a lawyer and a marketer would soon figure a way to avoid the impact of the regulation. Moreover, it is not really clear that money market funds are a major competitive threat.

What is the answer? There is no easy answer. In the short- and medium-run, if inflation, inflationary expectations and interest rates remain high, we will be in a difficult situation. We must choose between slowing the pace of deregulation of deposit rate ceilings and restricting all deposit substitutes or letting the market work. Either choice means allowing some depository institutions, including many thrifts, to disappear or requires providing them temporary support.

Unfortunately, that dilemma foreshadows a longer run danger. If we resort to the expedients of regulation and restraint in the short- and medium-run, then in the longer run there will be a temptation to renege on the fundamental decision to deregulate the deposit side of the balance sheet. Thus, the challenge for the committee and more broadly for the government is a serious one if inflation is not brought speedily under control.

In short, we will be forced to face whether we are willing and able to carry through with a major and, in our judgment, correct deregulatory effort, even though that means incurring short-run costs.

Geographic Restraints—The second competitive issue concerns geographic restraints on banking. We believe such restraints on bank expansion are anticompetitive and impede the effectiveness and efficiency of the financial system. In raising that issue, we want to emphasize our concern for the future of commercial banking.

Preservation of the McFadden Act and Douglas Amendment restrictions will continue to provide some banks with some protection from other bank competitors. In the meantime, however, institutions that are not similarly restricted will have ample opportunity to increase their share of the product markets in which banks compete. Even in banking, the interstate activities of loan production offices, Edge Act corporations, and nonbank affiliates of bank holding companies are making McFadden Act protection virtually meaningless in every area but deposit competition. Even in that area, advances in communications technology and deposit deregulation are reducing significantly the importance of such protection.

Moreover, since the beginning of 1980, federal savings and loan associations have been permitted to establish branches on a statewide basis. In addition, they may be permitted, in certain circumstances, to establish branches across state lines. When savings and loans implement their new powers, statewide branching and, potentially, interstate branching, will give them a substantial competitive advantage over banks.

The Congress has quite accurately perceived the confluence of issues surrounding geographic limitations on domestic banks and foreign bank expansion in this country. The International Banking Act of 1978 placed new limits on multistate expansion by foreign institutions and called for a review by the Administration of the old limits on domestic institutions. The General Accounting Office last year recommended a moratorium on foreign acquisitions of large U.S. banks solely because of the "basic unfairness" resulting from some foreign banks' ability, in certain circumstances

to purchase large U.S. banks that are unavailable for acquisition by domestic banking organizations because of antitrust policy and federal and state restrictions on bank expansion. That is an inequitable situation—an anomalous result of our own laws and policies. In our opinion, however, the unfairness problem should not be resolved by restricting foreign acquisitions.

For all those reasons, we are convinced that geographic restrictions must be dealt with now. Initially, the Douglas Amendment restrictions on interstate bank holding company expansion should be phased out, including restrictions on establishing new banks and acquiring existing banks. Such a phase-out might be implemented on a standard metropolitan statistical area basis, contiguous state basis or by regional groupings. Certainly, it should be possible for bank holding companies to acquire failing or floundering banks in other states. Moreover, states can and should begin eliminating competitive barriers on their own. The key point is to create new possibilities for acquisitions or combinations that could benefit the domestic banking system and the people it serves and to do it as quickly as possible.

The most troublesome aspect of such an approach is likely to be combinations of larger banks. Such acquisitions raise legitimate concerns about the aggregation of large amounts of financial resources that are not addressed by existing antitrust concepts or laws. One remedy would be to fashion a statutory policy requiring proponents to demonstrate not only that a proposed interstate acquisition would pass muster under traditional antitrust standards but also that substantial public benefits would be derived from the transaction.

We know that implementing those ideas will be difficult. Geographic restraints on competition lie at the very heart of American banking tradition. Nevertheless, it should be clear that interstate banking is already a reality. The power of the marketplace, propelled by technological innovations that reduce costs in an inflationary environment, is too great to stop. That leads inescapably to the conclusion that whatever the merits of the past debate on the McFadden Act and the Douglas Amendment, the competitive vitality of the commercial banking system depends importantly on developing solutions to the problems posed by those laws.

Product Segmentation and the Glass-Steagall Act—The third competitive issue for the agenda is segmentation of financial products through laws and regulations [illegible] and divide the various [illegible]. Although the road map [illegible] deregulation of geographic restraints and a road map could be charted for deregulation of geographic restraints, no map exists for rules which separate markets, primarily because the marketplace has only recently begun to focus attention on the issue. For example, although the questions of whether to restrict money market funds or to allow commercial banks to underwrite municipal revenue bonds are being discussed, more fundamental questions have yet to be systematically addressed.

In essence, the matter is simple: Should households or companies be able to satisfy their needs for financial services at one stop or should we continue to require specialization and predefine financial products through government fiat? The need to examine that question is substantial in the retail and corporate areas.

In the retail area, it appears that in the marketplace of the 1980s, consumers are willing to forego many of the protections offered by highly regulated depository institutions in favor of the convenience and benefits offered by unrestricted financial services supermarkets. The basic public policy issue that must be debated and resolved is whether the risks of removing all safeguards and protections are unacceptable regardless of the benefits obtained from unregulated competition. The process of debate and resolution of that issue must include an examination of the appropriateness of the existing rules of the game, which continue to perpetuate competitive inequalities among depository institutions and between the depository industry and other providers of financial services.

Our own preference is for substantial deregulation in the consumer financial services area. If insurance companies or multinational financial firms can own brokerage firms, if brokerage firms can acquire trust companies, if retailers can own savings and loan associations, if Merrill Lynch can offer brokerage services (real estate, commodities, securities, and insurance), money market mutual funds, cash management accounts, credit cards—the full panoply of consumer financial services—then it seems that the marketplace is already far down the road of dismantling product segmentation. The time has come, therefore, to begin the process of redrawing the road map.

In the corporate finance area, the need for reexamination is also apparent. The functions of commercial banks and investment banks should be considered in light of the evolving forms of financing by governmental and corporate customers. For instance, since enactment of the Glass-Steagall Act prohibitions in 1933, municipal revenue bonds have become an increasingly important method of state and local government financing. Unlike general obligation bonds, however, municipal revenue bonds cannot be underwritten by

commercial banks. Similarly, in the corporate finance area, many of the larger corporations now view short-term borrowing in the commercial paper market as a substitute for short-term loans. Yet, the authority to sell third party commercial paper has been subject to judicial challenge by the securities industry on the theory that such activity is prohibited by the Glass-Steagall Act. Further encounters of that nature seem likely absent authoritative legislative resolution.

We believe the time has come to reexamine the financial intermediary system which has evolved within the confines of the Glass-Steagall Act. That reassessment should focus on the appropriateness of the Glass-Steagall prohibitions and on what lines of demarcation make sense with respect to today's financial needs and regulatory environment. Because the potential for undue concentration of economic power entails legitimate concerns, we believe that proposals to expand bank underwriting and dealing in securities should be subjected to rigorous and dispassionate scrutiny. At the same time, that scrutiny should include the clear potential for forming huge financial conglomerates outside the bank regulatory system and the competitive disadvantage which overregulation may be imposing on that system.

Supervisory and Other Statutory Issues

A reexamination of the statutes dealing with regulation and supervision of depository institutions is also needed. There are things that can and should be done which would accomplish intended regulatory objectives in ways that are more effective and efficient.

Because of the economic and social costs of widespread or frequent bank failures, the traditional mission of state and federal bank regulators has been to maintain the soundness of the banking system: to spot potential problems in banks before they become serious, to take action to correct the ones that do, and to act in ways that limit failures without unduly inhibiting the free play of market forces. System soundness, however, is not our only concern. We are also charged with the oversight of banks' corporate and trust activities, the enforcement of many consumer protection laws, and the regulation of banks' securities offerings and reports to investors.

The challenge of regulation is to achieve those mandates in the least burdensome way. The regulatory burden manifests itself in many forms: archaic statutes, inflexible laws, paperwork requirements, resources diverted to developing and maintaining compliance systems, time spent responding to examiners during on-site examinations and loss of flexibility in decision-making.

Accordingly a comprehensive agenda of statutory and supervisory issues should include a reexamination of existing federal laws to determine how they might be revised to enable regulators to achieve their objectives in the least burdensome ways; it should include analysis by regulators to determine ways to reduce the burden of compliance with the mandate of existing laws; and it should involve an evaluation of how to use limited agency resources more efficiently.

There is danger in pursuing that agenda in piecemeal fashion. For example, arbitrary reduction of paperwork requirements may prevent development of even less burdensome remote supervisory monitoring techniques that must rely on the submission of detailed data. Moreover, care must be exercised to assure that one goal such as efficient and effective consumer protection is not sacrificed at the expense of another such as paperwork reduction. As the review proceeds, it would be well to keep those considerations in mind and to rely as much as possible on market-based approaches and self-policing techniques to achieve regulatory missions.

Consumer Protection and Fair Lending Laws—The cry of unnecessary paperwork and regulatory burden is frequently heard with respect to the consumer protection statutes. Those statutes have introduced disclosure, public notice, recordkeeping and reporting requirements. Enacted over the past 13 years, those laws are intended to ensure that bank customers are well-informed and protected against bank error and abuse. However, as the range of bank practices covered by such legislation has grown, consumer protection and fair lending requirements have become increasingly burdensome. Moreover, it is not clear that in all cases burdens have been adequately justified by consumer benefits. It is clearly time to examine those laws systematically, to simplify them and to develop more flexible ways of administering them to ensure that the costs do not outweigh the benefits. As we proceed, however, we must bear in mind that as banking becomes even more complex and the range of services even more diverse, the need to educate bank customers and to guard against bank error and unfair practices will become more important

Most of the consumer protection objectives have resulted in disclosure requirements implemented by regulations that attempt to anticipate types of loan transactions and specify the exact information to be contained in the disclosure notice. The most obvious example is the Truth-in-Lending Act There are other major credit disclosure laws such as the Fair Credit Billing Act and the Real Estate Settlement Procedures Act that need attention Other consumer laws such as the Equal Credit Opportunity Act also have requirements that could be simplified or repealed

Some of those disclosure requirements have been developed piecemeal over 13 years without a great deal of thought to the costs involved for the lending institutions and their customers. As a consequence, each has its own distinct legislative and regulatory process. The end result is that lenders have had to spend a great deal of money on designing, filling out, and retaining forms. Consumers, on the other hand, receive lengthy, complex, overlapping and sometimes confusing series of separate disclosures.

Some progress has been made in reducing the burden of those requirements, most notably the Truth-in-Lending Simplification and Reform Act passed by Congress a year ago. However, that law fell considerably short of comprehensive simplification. Moreover, the act did little to reduce the overlap of disclosure requirements affecting, for example, real estate transactions.

For those reasons, comprehensive examination of the entire area of consumer disclosures, encompassing credit-related disclosures and others, should be undertaken. We recommend that Congress consider appointing a special commission of legislators, industry representatives, a cross-section of consumer representatives, state officials, agency officials, and academic experts to conduct that review. We recognize that appointing a commission to study a problem can sometimes be a formula for delaying rather than expediting its resolution. Nevertheless, we feel strongly that a piecemeal review of the consumer protection statutes should be avoided. If those laws are reviewed and reformed one by one, the end result will almost inevitably be a continuation of the uncoordinated and duplicative type of system we have now, to the detriment of lenders and consumers. We believe a commission would be preferable to the normal legislative process because it might have the capacity and perspective to study those extraordinarily complex issues in a comprehensive and highly analytical manner that is necessary for practical reform. As complex as those issues are, we believe a review would be finite and manageable and could be completed within six months.

Several principles should be kept in mind during a review. First, the more the marketplace is permitted to offer variety in complex areas where consumers have difficulty understanding their options, the greater the possibility there is for consumers to be intentionally or inadvertently misled. If the market is to operate efficiently, consumers must be able to pursue their interests based on adequate information. Thus, we may expect to [illegible] pressures build in the future for [illegible] alternative to outright regulation [illegible].

Second, more work should be done in permitting deregulation of small institutions. A major step has been taken through the Regulatory Flexibility Act passed last year requiring federal agencies to consider the impact of new regulations on small businesses, exempting them from requirements where feasible and appropriate. There is no question that small banks are often ill-equipped to deal with the complexities of the consumer protection statutes.

Third, we believe the burden of compliance systems should be reduced for lending institutions with good records of self-policing and effective internal procedures for complying with consumer protection statutes. For example, record retention requirements could be eased or removed for lenders with consistently strong examination results. Such an approach would give institutions an incentive to maintain an excellent record in that area and would permit agencies to focus supervisory resources on institutions where serious problems exist.

Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA)—In 1978, Congress enacted broad financial institution regulatory legislation through FIRA to prevent perceived abuses in banking practices, particularly in borrowings by bank insiders. The law imposes rigorous conflict of interest standards, burdensome recordkeeping, reporting, and disclosure requirements, and new federal supervisory controls on the conduct of federally supervised institutions. Its provisions, however, are frequently duplicative and, in some instances, inconsistent.

The five federal supervisory agencies represented on the Federal Financial Institutions Examination Council forwarded proposed legislation to the committee to make technical changes and correct obvious procedural problems encountered in implementing and administering FIRA provisions. In addition, we recommend a more extensive review to provide simpler, yet effective, legislation in certain areas addressed by FIRA.

The many-layered nature of FIRA is shown by the several statutory procedures, prohibitions, and sanctions affecting borrowings by bank insiders from correspondent institutions. Under Title VIII, an insured bank is prohibited from making a preferential loan to any insider of another bank for which it maintains a correspondent account. Unlike other provisions of FIRA concerning loans by a bank to its insiders, however, Title VIII does not prohibit such a loan to the related interests of an insider of a correspondent institution. Nevertheless, the statute requires that each executive officer and principal shareholder of an insured bank make a detailed written report concerning his or her

borrowings and those of related interests from correspondent institutions. Each bank must then file a separate written report to its federal supervisory agency to identify all such executive officers and principal shareholders and the aggregate amount of their borrowings from correspondents.

The usefulness of those recordkeeping and reporting requirements and similar requirements under Title IX for other insider transactions should be reconsidered. The prohibitions and the arbitrary ceilings on loan amounts of the statute should either be repealed or amended to permit broader flexibility to institutions to make credit determinations in light of the specific characteristics of a loan and the creditworthiness of the intended borrower. A simplified recordkeeping or reporting mechanism, coupled with supervisory penalties and potential civil liability, may adequately accomplish the purposes of the law.

We would welcome the opportunity to assist the committee in reviewing FIRA.

National Bank Act—While it is clear that recent laws passed by Congress should be evaluated, we also believe it is time for a comprehensive review of the National Bank Act. Many provisions of the federal banking laws are no longer as appropriate as when they were enacted up to 100 years ago. Several provisions should be either repealed or substantially amended to ensure the ability of national banks to meet the evolving needs of our changing economy.

We have already begun to study some of the more troublesome provisions, and certainly others deserve serious scrutiny and, perhaps, revision or repeal. For example, the principal terms of section 84 of title 12 of the U.S. Code have remained essentially unchanged since 1906. The intended purpose of the law, which restricts loans to individual borrowers to 10 percent of a bank's capital and surplus, was to promote diversification of risk and to spread the benefits of a bank's lending capacity throughout its community. Because of that limitation, however, banks, particularly smaller ones in rural communities, frequently are unable to meet their customers' credit needs. In addition, many states have considerably less restrictive lending limitations for state-chartered banks, resulting in a competitive disadvantage for national banks. There is no evidence that less restrictive limits under state law have increased the level of risk. Accordingly, we are considering proposing changes that would enable national banks to compete more effectively and would simplify the current complicated statute.

Similarly, section 82 of title 12, an original provision of the 1864 law, generally limits a bank's aggregate nondeposit liabilities to 100 percent of capital and 50 percent of surplus. Since 1913, that provision has been amended several times to prevent interference with certain national goals such as war production, agriculture, housing and foreign trade. Confusion about applying that statute has resulted in more than 100 interpretive rulings and opinion letters. Given our current supervisory powers, we are studying whether that law is necessary or whether it should be amended in a way that provides greater flexibility to banks to manage nondeposit liabilities.

Existing federal law also imposes arbitrary ceilings on the ability of banks belonging to the Federal Reserve System to issue bankers' acceptances, one of the principal means used to finance foreign trade. In recent years, many banks engaged in trade financing have reached their legal ceiling. We believe relaxation of that limitation would assist our balance-of-trade position without adversely affecting bank soundness. Therefore, we recommend review of sections 372 and 373 of title 12.

We are also considering revisions to the restrictions imposed on national bank real estate lending activity by section 371 of title 12. Those restrictions were intended to put real estate lending on a safe and sound basis. However, they might unduly inhibit national bank participation in the evolving residential real estate finance market. In particular, the rigid loan-to-value ratios, the 30-year amortization requirement and the aggregate limitations on total real estate lending, construction lending, and second-lien real estate lending are often at variance with evolving market realities, deterring national banks from engaging in transactions that could at once be prudent and profitable and satisfy borrower needs. In the past, we have suggested a revision that would authorize national banks to make real estate loans subject only to any limitations that the Comptroller might from time to time impose. We intend to propose similar legislation in this session of Congress.

Finally, the normal transactions between affiliated banks are, in our opinion, unduly hampered by the statutory ceiling in section 23A of the Federal Reserve Act (12 USC 371c). The Federal Reserve Board has for several years proposed legislation to permit greater flexibility in dealings between affiliates.

Bank Capital Requirements—While some regulatory reform actions must rely on congressional initiative, many others can be pursued by the regulatory agencies. One initiative we are taking is in the area of bank capital requirements.

The pivotal role that larger banks play in the national and international financial community gives them a

responsibility to help preserve stability and confidence. Thus, it is particularly important that those institutions maintain capital positions that adequately support the volume and variety of activities they undertake and that assure continuing public confidence in their operations and in the financial system as a whole. Last year, we indicated our concern about the long-term trend toward increased leverage in those institutions and outlined a supervisory program to address that matter. In 1980, we implemented the initial phase of the program by conducting comprehensive reviews of the capital plans of the largest banks. Similar supervisory programs are being developed to address the capital adequacy of regional banks. While those programs are necessarily long-term endeavors which may be modified periodically, we believe the approach is an effective means of ensuring adequate capital levels for those companies as a whole. We are prepared to bring regulatory pressure to bear on banks to correct capital shortfalls, present and prospective, as needed.

In smaller community banks, the issue of capital is one of disparity of treatment—smaller banks generally have capital ratios significantly higher than larger banks. In recent years, many small community banks have made significant strides in acquiring and developing depth and quality of management, level and quality of earnings, quality of assets, geographical diversification, effective internal planning, operating and control systems, market presence and reputation, broad risk diversification in assets and liabilities, exposure to the disciplines of the public markets and other characteristics which generally justify lower capital ratios for larger institutions. We recognize those factors, collectively, have more to do with the financial strength and health of a bank and, hence, its capital adequacy than the magnitude of its capital ratio.

As community banks continue to adopt many of the sophisticated management systems techniques, policies, procedures and controls generally characteristic of larger banks, a policy of permitting sound and well-managed banks to reduce their traditionally high capital ratios becomes appropriate. Moreover, we have improved our ability to examine and monitor bank activities. We have developed techniques for identifying banking problems in their early stages on an individual bank basis. That has enabled us to initiate corrective action often before a problem gets out of hand.

Although lower capital ratios may pose some additional risk, we are convinced that the majority of smaller banks can operate prudently with lower ratios. We believe the benefits of more aggressive, competitive smaller banking organizations will outweigh the increased risks lower capital ratios might pose.

Examination and Supervisory Approach—We also recognize the continuing need for reviewing and adjusting our examination and supervision approach to the changing environment. In January, we established a task force of senior agency officials to examine carefully the environment in which financial institutions will likely be operating in the 1980s and to determine where changes should be made in our supervisory approach. The intent is to anticipate changes in the banking environment and structure and redirect our resources in the most effective and efficient manner.

We have begun by attempting to understand how the environment may change over the next decade and how the financial system will be affected. Simultaneously, we are looking at our organization to determine strengths and weaknesses. In the next phase, we will review supervisory philosophy and assess how new and developing technology can be used to conduct the types of examinations that will be needed, both on-site and off-site. In the final phase, we will develop and implement plans for responding to those anticipated changes.

Since the 1970s, the national banking system has experienced an explosive growth in assets, sophistication, and technology, and Congress has also given the office significant new responsibilities for implementing new banking and consumer protection laws. To keep pace, we have reallocated resources toward new programs to accommodate those changes and away from safety and soundness examinations. Thus, the time between on-site examinations has lengthened dramatically.

At the same time, governmental actions over the past few years, including hiring freezes and employment ceilings, have kept us from adding to our field examination force. Our ability to continue supervising the national banking system effectively and to implement the strategic plan in the years ahead, therefore, will depend on two critical factors: (1) efficient use of scarce human resources and (2) continued modernization of off-site monitoring and analytical techniques, particularly through computer technology.

Recognizing present and anticipated future resource constraints, we are considering several approaches to accomplish our mission. In general, more off-site analysis will probably take place to pinpoint areas of concern. In smaller well-managed banks, on-site examinations will probably be conducted less frequently. That does not mean, however, that we will stop monitoring each bank's performance or stop communicating our views and concerns; rather, less of that would be done on-site. The monitoring techniques available through the national bank surveillance system will be used to detect trends and conditions in individual

banks and in the banking system as a supplement to less frequent onsite examinations. A calling program may also be used with an examiner visiting senior management to discuss the bank's performance and changes in management's future plans. We currently use several of those off-site monitoring techniques quite extensively in supervising our largest banks in the Multinational Division and to a more limited degree in the smaller banks.

To be effective substitutes for the on-site examination, off-site computer-based examination, monitoring, and analytical techniques will require increased financial reporting by banks. However, such requirements would run counter to laws and policies aimed at reducing the paperwork burden. The objective of paperwork reduction is good and one that we support. However, arbitrary paperwork reduction requirements could preclude adoption of more efficient and less costly supervisory approaches. If we cannot develop such approaches because of inadequate information and we continue to experience substantial personnel cuts, our ability to supervise the national banking system effectively may be seriously jeopardized in the years ahead.

In addition, we have made substantial progress in reviewing and changing our examination and enforcement procedures for the Community Reinvestment Act, the civil rights laws, and the consumer protection laws. We undertook that review for two reasons. First, the number of laws and regulations covered by the consumer examination has been growing far faster than our resources, creating a need to refocus our examination. Second, we recognized that the consumer examination was ready to evolve from its past orientation as an essentially technical compliance review into a subjective, judgmental evaluation of bank performance. With that recognition came a need for new consumer examination procedures and, importantly, a higher level and breadth of experience in the examiners using them. We are preparing to test an entirely new set of procedures and an examination team concept that relies on senior level examiners. The new system will take a common sense approach, focusing increased supervisory attention on banks with serious deficiencies while reducing the compliance burden on the well-managed, well-intentioned institution.

International Supervisory Cooperation—We are also concerned with ensuring effective supervision of the international activities of banks. The growing internationalization of the banking industry has caused supervisory authorities from the leading industrialized nations to work toward better mutual cooperation and communication. Events affecting banking organizations and markets in one country can have ripple effects elsewhere. The expansion of banking organizations from the home country into other locations necessitates working relationships and coordination among parent country and host country supervisors.

Supervisory authorities have benefitted from increasing communications, formal and informal contacts, and efforts to coordinate their activities. The Committee on Bank Regulations and Supervisory Practices, formed in 1974 under the auspices of the Bank for International Settlements, is perhaps the single most important forum for constructive interchange and cooperative efforts among supervisors of different countries. The committee's main focus has been developing broad principles and standards on which bank supervisors can agree, notwithstanding the differences in banking laws and regulatory practices among the countries represented. For instance, the committee has supported international standards for bank accounting on a more consolidated basis than now exists in many countries.

The committee also provides a forum for bank supervisors to compare supervisory approaches, identify gaps in the regulatory coverage of international banking, develop guidelines that delineate the responsibilities of host and parent authorities, and exchange information of a sensitive nature derived from different sources. The committee has been instrumental, for example, in promoting legislation abroad to facilitate arrangements among supervisors for confidential exchanges of information. The European Economic Community (EEC), in its first banking directive, provided for exchanges of banking information among member banking authorities to strengthen the supervisory process within the EEC. On that point, we strongly support the recommendation of the Federal Reserve Board in its report to the Congress on the International Banking Act that the act be amended to provide additional specific statutory authority for confidential treatment of exchanges of information between foreign bank holding companies and U.S. banking agencies and between those agencies and their foreign counterparts.

Regulatory Structure

Traditionally there have been five federal regulatory agencies charged with supervising the federally chartered and federally insured domestic depository institutions. Moreover, one or more state regulatory agencies in each of the 50 states are responsible for supervising the state-chartered institutions. In the last three years, Congress has added two more federal regulatory bodies, the Federal Financial Institutions Examination Council and the Depository Institutions Deregulation Committee.

The subject of the optimal structure of the agencies responsible for supervision of deposit-taking institu-

tions is hardly new, but the reasons for addressing it carefully have never been more urgent. Indeed, we are convinced that the benefits to be derived from reorganizing the existing system substantially outweigh the costs. The existing framework is increasingly inefficient and should not be tolerated in a world of expanding agency missions and limited government resources. The challenge is to design a framework that is suitable for today and sufficiently flexible to accommodate change.

There are several reasons for believing that we should move immediately toward shaping a new regulatory and supervisory framework.

One reason—the need for effective supervision of a bank holding company and its component parts—is obvious. Over two-thirds of the multibank holding companies have at least one bank which is nationally chartered *and* at least one bank which is state-chartered. Indeed, it is not uncommon for a holding company system to include national banks, state member banks and state nonmember banks, sometimes in several states.

The possibilities for regulatory confusion and duplication are real and present concerns. It is not sensible for a multiplicity of regulators to have safety and soundness jurisdiction over segments of an integrated business enterprise. Inevitably, that approach will be conflicting and uncoordinated at times. Moreover, the existing framework confronts bank managers with duplicative and sometimes inconsistent regulatory demands.

Some admittedly modest steps are being taken to rationalize the system. Under the auspices of the examination council, the federal bank supervisory agencies have begun coordinating federal examinations of all bank holding companies with consolidated assets exceeding $10 billion and certain other classes of companies requiring special supervisory attention. In addition, the agencies are attempting to coordinate examinations of all other bank holding companies and their bank subsidiaries where resources permit.

To improve productivity, the OCC is developing a system for examining multibank holding companies and their national bank subsidiaries from the holding company level, using the company's plans, policies, and internal monitoring mechanisms as source material. For the largest bank holding companies, a new financial analytical model is being developed to focus on the [illegible]. That may result in less frequent [illegible] significantly reduced [illegible]

Those modest steps are worthwhile and point in the right direction, but they do not go to the heart of the matter. What is needed is a unified supervisory perspective on, and authority over, the whole corporate entity.

Our second reason for favoring reexamination and modification of the current structure arises from our belief that we simply must make more effective use of the limited supervisory resources at our disposal. Creation of the examination council reflected a desire for greater uniformity in training examiners and in the methods of examination, supervision and data collection used by the Federal Reserve System, Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, National Credit Union Administration, Comptroller of the Currency, and state supervisors.

We support the examination council's goal of achieving greater uniformity in regulation because of our belief in the more basic principle of applying equal regulatory and supervisory standards to similarly situated participants in the financial system. However, defining who is similarly situated and achieving agreement among agencies on the principles of how to proceed in areas of regulation and supervision are difficult. Even when agreement on principles can be achieved, ensuring uniform implementation through management systems of the different agencies is cumbersome at best and perhaps impossible in some instances. Thus, despite the examination council's progress, we are convinced that it is an inefficient tool for coordinating the activities of independent regulatory agencies. Therefore, the time has come to move beyond the examination council.

Our third reason for advocating modernization of the current structure, and we recognize that reason is most sensitive politically, is the blurring of distinctions among deposit-taking institutions. Thrift institutions, armed with new powers, are in banks' business— transaction accounts, credit cards and other forms of personal credit—and banks are in the thrifts' business—evidenced particularly by their growing participation in the residential mortgage market. We favor a framework which, at all levels, provides for equal regulatory treatment of equally situated players. The new asset and liability powers of the thrifts underscore the need to include them in a restructured regulatory framework.

A regulatory structure which ignores marketplace realities will only perpetuate anachronisms and delay—or make more expensive and painful—the very adjustments the financial industry must go through.

The numerous options suggested over nearly 50 years for modifying the current structure need not be re-

peated. Indeed, either of two basic options proposed, a single agency or separate agencies for federally and state-chartered depository institutions, could be structured to resolve the three immediate problems that we identified. Other options certainly exist. We do strongly suggest, however, that the time has come to proceed with a rationalization of the structure in a way which at least resolves those three problems. In that process, a number of issues should be addressed, including:

- What is the appropriate role for the states in the evolving multistate financial services system?
- What is a responsible, practical distribution of supervisory authority over smaller, locally oriented institutions?
- How should the regulation of the financial activities of nondeposit-taking organizations be coordinated with the regulation of banks and thrifts?
- How should the regulation of financial institutions be coordinated with the regulation of providers of telecommunications and similar technologies on which financial institutions increasingly rely and use in local and multistate environments?
- Where should responsibility be lodged for the protection of investors in deposit-taking companies?

From my point of view, having been Superintendent of Banks of the State of New York, Acting Chairman of the Federal Deposit Insurance Corporation, and a member of its board and Comptroller for almost four years, I believe that the banking regulatory structure ought to be consolidated into an independent banking commission. I further believe that the commission should include the present supervisory and regulatory responsibilities of the Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, Federal Reserve System, National Credit Union Administration, and Comptroller of the Currency.

In conclusion, I would simply highlight the agenda that is before us. It is useful to identify two categories of items.

There are the laws, regulations, and policies which segment markets, geographic and product, and regulate price—in short, the rules and boundaries of the game of financial competition. In those areas, we must recognize that, like it or not, technology, inflation, and marketplace vitality have assured deregulation. The task before us is to provide deposit-taking institutions the capacity to compete and serve the public effectively while minimizing the potentially disruptive consequences of dramatic change. That task must be continually pursued with heightened urgency. It has at least three facets.

First, the process of phasing out interest rate ceilings must continue apace. To waver in the policy commitment of the 1980 act might severely damage—perhaps irreparably—the role of deposit-taking institutions, thrifts and commercial banks alike, as providers of financial services to individuals. In that regard, I would emphasize the immediate need to agree on a strategy for addressing the earnings problem of thrift institutions in the short run, allowing us to provide all deposit-taking institutions the flexibility to compete for funds in the marketplace. From my perspective, we should have tools, in case rates remain high, to provide adequate regulatory flexibility to facilitate mergers of weaker institutions and, where appropriate, to assist institutions in extremis. I am hopeful that we will resist the temptation to address the thrift problem by imposing new regulations intended to hamstring competition.

Second, the time has come to decide on elimination of geographic restrictions embodied in the Douglas Amendment and the McFadden Act. I recognize that the politics are not easy. Moreover, there is no plan for deregulation which is perfectly equitable or which eliminates the possibility of some dislocation. Nevertheless, further study and delay will not provide additional illumination, nor will it make the decision about how to proceed any less difficult. I am hopeful, therefore, that this session of Congress will chart a course for the deregulation of geographic restraints on deposit-taking institutions just as the last session of Congress did so with respect to deposit rate controls. As with rate ceilings, each year that restraints continue, the strength of our depository system will be sapped.

In pinpointing that issue for immediate action, I am not suggesting that it should have highest priority. I am fearful that debate with respect to that subject will in the coming years interfere with our addressing other more important fundamental issues. Rather, I mean simply to underscore that the question of geographic restraints is ripe for decision, that the failure to act may take it out of Congress's hands forever as events in the marketplace moot the question and that banking generally will suffer if that happens.

Third, and most importantly, the time has come to reexamine the various laws, regulations and policies that since the Depression have served to separate the providers of financial services. That implies, of course

a systematic review of the Glass-Steagall Act. The debate should not, however, be limited to a traditional formulation of the issues. The roles of all providers of financial services—insurance companies, retailers, etc.—and the appropriate function of the government in defining those roles should be addressed. I am hopeful that we can in the coming months define a process for study and debate so that the next session of Congress will be able to consider those issues in a systematic and orderly fashion and come to some resolution.

The second category of items on the agenda addresses regulatory reform. It is imperative that we continue and accelerate the process of reform that has begun. Deposit-taking institutions are the most regulated of financial providers. In most cases, they marked a reasonable response to a legitimate need. However, taken as a whole, they create a bewildering and conflicting maze—much of which is antiquated and much of which is excessive.

The process of regulatory reform is one which Congress and the agencies must share. In some cases statutory change is required, and in some it is not. In that process, we must ask several questions:

- Is the goal of a particular statute or regulation still a desirable one and one which warrants governmental intervention?
- Is the strategy chosen to achieve a particular goal an effective one?
- What is the cost of achieving the goal?
- Have we chosen the most efficient possible means to achieve the goal?

By advocating, in effect, cost/benefit analysis, I do not mean to suggest that the exercise is scientific or subject to quantification. It is not. For example, how does one place a value on the benefit of strategies designed to ensure confidence in our financial system? Nevertheless, I do believe that it is possible to proceed in a systematic, thoughtful, and comprehensive fashion. The process of regulatory reform has at least four parts.

First, the time has come to reorder our financial regulatory structure and by that I mean to include the regulatory framework for all providers of financial services. Although there is no significant constituency for that change, our present framework is increasingly out of touch with reality. Whatever reform occurs elsewhere, failure to address that issue will ensure increasingly inefficient and costly regulation. In my judgment, that subject demands higher priority than constituent pressure would accord it.

Second, we should reexamine our civil rights, consumer protection, and Community Reinvestment Act strategies to enhance *both* effectiveness and efficiency. As I indicated, we have undertaken a comprehensive review of our own policies and procedures. Legislative changes may be required. To that end, we have suggested creation of a congressional commission to undertake a comprehensive review and report back to the Congress within six months.

Third, I would emphasize that while it is popular to focus on those statutes as examples of costly and burdensome regulation, such a singular focus is inappropriate. The statutes are not alone nor are they necessarily the worst offenders in terms of imposing undue and/or unrecognized costs on depository institutions and their customers. Accordingly, Congress and the agencies should also focus on other groups of laws and regulations. For example, simpler yet effective legislation in areas designed to prevent perceived abuses in banking practices, particularly relating to borrowings by bank insiders, is possible. Moreover, many of the provisions of the National Bank Act are no longer appropriate and should be revised or repealed. We look forward to working with the committee on such issues and anticipate making a series of specific proposals in the coming months.

Fourth, we in the agencies should reexamine our approaches to examination and supervision in light of resource constraints and the changing nature of the financial services industry. We are implementing programs to review the capital plans of larger banks and to ensure adequate capital levels. At the same time, we are permitting sound and well-managed smaller banks to reduce their capital ratios. Those programs are aimed at strengthening the national banking system and improving the competitiveness of national banks. In addition, as I indicated, we are developing new approaches and analytical techniques for examining and supervising national banks which respond to changing market realities, focus our efforts on the more significant problems and areas of risk and conserve our limited resources.

We recognize that outlines a sweeping agenda for the Congress, the agencies and the industry. Our perspective might well be criticized on the grounds that to undertake the changes is unrealistically ambitious and politically impossible. In retort, I would suggest simply that there is little choice. For the reasons I have outlined, the business of providing financial services to individuals, to companies, and to governments will change radically. Law, regulation and public policy can

facilitate orderly change, preserving the worthwhile values of our existing institutional framework. Or, it can serve as a source of uncertainty, an arena for gamesmen and an impediment to deposit-taking institutions. Which occurs is a matter largely in the hands of Congress and the regulatory authorities. In my judgment, nothing less than the long-run health and stability of the financial system is at stake.

Remarks by Paul M. Homan, Senior Deputy Comptroller for Bank Supervision, before the Conference of State Bank Supervisors, on supervision and examination policies of the Office of the Comptroller of the Currency in 1982, New Orleans, Louisiana, April 19, 1982

I would like to discuss some new directions in supervisory and examination policies and procedures being taken by the Office of the Comptroller of the Currency. The new directions are consistent with two of the major supervisory goals which grew out of our strategic planning exercise last year:

- To utilize our scarce resources in ways which will maximize our efficiency in carrying out the mission of our office.

- To develop a supervisory posture which is consistent with our goal of taking all the steps toward deregulation that are compatible with the public interest in maintaining a safe and sound banking system.

Successful achievement of these goals should enable us to reduce significantly the burden of regulatory on-site examinations and at the same time preserve the integrity and effectiveness of the examination and supervision process through the use of high technology.

In recent speeches the Comptroller has described how these goals will be achieved:

> This necessarily will involve a shift of OCC resources to the industry segments that represent the greatest risk to the banking system as a whole i.e., from smaller to larger banks and from well-managed banks to not-so-well managed banks—without increasing the burden of regulatory compliance.

Multinational Banks

We began shifting our resources in 1979 when we established our Multinational Banking Division. This division was given centralized supervisory responsibility for the 11 largest national banks, which hold 44 percent of the assets of the national banking system.

Since the establishment of this division, we have dramatically altered the examination of these global institutions. We have moved to a program of nearly continuous examination, analysis, monitoring, and supervision, relying heavily on the banks' management information systems and computer technology.

We use on-site examiners to test the integrity of the bank's own internal control and management information systems. Comprehensive examinations are performed once a year and are customized for each bank. We use quarterly on-site visits to gather and assess key financial information, update the bank's performance, note key changes in the bank's strategic plans. In addition to the on-site examination process, computer-based monitoring, analysis, and financial modeling take place continuously. Finally, there is a heavy emphasis on frequent communication with key officers of these banks. In fact, there are few business days which pass without one of the OCC's people being in contact with each of the multinational banks.

This process enables the OCC to keep abreast of changing conditions in these banks. The product is timely and far superior to anything we have had in the past. While the process appears to be resource intensive, we have in fact realized manpower savings of 20 to 40 percent when compared with the process we used for these banks during the late 1970s. We also believe that the new procedures are far less burdensome on the banks than the old ones.

In addition to examination efficiency and reduced burden, a very important advantage of these procedures is more timely information. Because of the rapidly changing financial markets, wide swings in interest rates and volatile economic conditions we have seen in the last three years, all of us have learned the hard way how such factors can quickly result in problems for certain banks. As bank supervisors we have also learned that although the traditional, periodic on-site examination is an extremely valuable tool, it must be supplemented with supervisory techniques that will keep us current on conditions in banks between comprehensive examinations. That is why we have made heavy investments in developing the techniques that I have described, using computer-based technology whenever possible.

Regional Banks

In late 1981, we decided to apply the same type of examination and supervision policies and procedures to the regional national banks. We generally define regional banks as those with assets between $1 billion and $10 billion. There are 119 regional national banks

and they hold approximately 28 percent of the total assets of the national banking system.

Each of our regional offices will implement a regional bank program in 1982. Regional banks will continue to receive an on-site comprehensive examination each year. In addition, the visitation, analysis, monitoring, examination, supervision, and communication procedures in use for multinational banks will be applied.

Community Banks

We call the remaining 4,323 national banks community banks. These are banks with less than $1 billion in total assets. Although they comprise 97 percent of the total number of national banks, they hold only 28 percent of the assets of the national banking system. We are developing policies and procedures which will greatly reduce our on-site presence in community banks for implementation in late 1982. At the same time we will increase reliance on computer-based analysis and monitoring to keep us current on conditions in these banks. We hope to realize significant efficiency and productivity gains and reduce the burden of the on-site examination.

We have already implemented a change in our examination scheduling policy for well-managed community banks. Generally, banks with assets between $300 million and $1 billion will receive a "detailed" examination once every 24 months; banks with assets less than $300 million will receive a "detailed" examination once every 36 months.

A "detailed" examination involves an in-depth integrated examination covering commercial, international, EDP, consumer, and trust activities. The procedures for this type of examination will be developed for use by the latter part of this year. The "detailed" examination will entirely replace the current "general" and "specialty" examinations for community banks. An annual review and visitation will be scheduled in the years between "detailed" examinations. We are currently testing the annual review and visitation program and intend to implement it during the second half of 1982.

The premise underlying this program is that banks in sound condition which have not experienced significant changes in policies, procedures, management, ownership, or financial performance are generally resistant to the effects of adverse external factors, and can be expected to maintain their sound condition.

This program combines off-site analysis with a short on-site visitation program. The off-site analysis will [illegible] the reports of condition and income, performance [illegible] from the National Bank Surveillance System (NBSS), the most recent report of examination and its associated work papers, correspondence, environmental information, and specific additional information requested from the bank.

The annual visitations are a crucial part of the new procedures. They will be conducted by an experienced examiner, usually one who is familiar with the bank being examined. Examiners with experience in specialty areas may also participate.

The on-site reviews are expected to take two to five days for banks under $300 million and two to 15 days for banks with assets of $300 million to $1 billion.

During a visitation, examiners will pay specific attention to any areas of concern disclosed by the off-site review. A brief letter that summarizes the results of the visitation will be provided to the bank. If there has been a significant deterioration in the bank's condition, a more comprehensive examination will be scheduled.

Problem Banks

We have made no significant changes to our examination scheduling policies for problem banks. Such banks will continue to receive on-site examinations at least twice a year and will be subject to continuous monitoring, analysis, and supervision.

Conclusion

We are optimistic that the supervisory approach I have outlined will make the best and most efficient use of our scarce resources, will allow the maintenance of a sound and effective national banking system, and will be consistent with our goal of moving toward deregulation.

There is one last issue which I would like to bring to your attention. It seems to me that the key to our collective ability to supervise and regulate the banking industry effectively and efficiently lies in our ability to collect essential, accurate, and timely financial information from the banking industry. Indeed, the new directions which I have described depend on a sound computerized database being available to the regulators.

As you know, our financial database is largely dependent on information gathered from reports of condition and income. This information base is generally very comprehensive and extremely useful to all of us. Yet it is woefully deficient in certain key areas, most notably:

- Maturities of assets and liabilities;

- Interest rates paid on assets and liabilities.

- Proportions of fixed and variable rate assets and liabilities;

- Quarterly interim income and expense information.

In today's banking environment every banker needs such information at his fingertips to manage a bank properly. Every regulator needs the same information to do the job properly.

The federal banking agencies have been engaged for some months in an effort to revise the reports of condition and income and fill some of the information gaps. It has become evident from our discussions with bankers that many banks do not have the systems that are needed to provide us with the precise information we would like to have. We are attempting to construct supporting schedules that take into account the current capabilities of bank management information systems. At the same time, we are planning to develop minimum standards of data that will eventually be required from all banks. After an appropriate phase-in period, we believe that banks will be able to generate, for their use and ours, the type of data needed. Significant costs may be incurred by banks in creating adequate information systems, but we believe such an investment is crucial, if all of us are to operate successfully in the banking environment of the 1980s.

When the revised Reports of Condition and Income are released for comment, we would very much appreciate both your suggestions for change and your support for what we are trying to accomplish.

Remarks by C. T. Conover, Comptroller of the Currency, before the Institute on Financial Services, University of San Francisco School of Law, on the impact of new market forces on federal regulation of financial services, San Francisco, California, September 13, 1984

The financial services industry is undergoing the greatest degree of change in its history. We are all participants in that change. As such, we have a vested interest in seeing that the result is a free and competitive marketplace in which everyone has the opportunity to thrive and flourish.

The forces behind the change have been many. Technology has made it possible to do things more quickly and cheaply than anyone could have imagined 50 years ago. The financial market is no longer local; it has become national, even global, in scope. There have been a host of cultural and social changes in our society that have resulted in a more sophisticated and more demanding consumer. As each segment of the financial services industry has tried to react to these changes, the net result has been a significant increase in competition in the marketplace.

Today, I'd like to talk about the impact of these market forces from a regulator's perspective. To do that I will discuss three things:

- Changes in the marketplace;
- Adapting the legal structure to meet marketplace needs; and,
- The regulatory response to change.

Changes in the Marketplace

With the advent of high technology, the removal of interest rate ceilings on deposits, the narrowing of interest spreads, and the progress of product and geographic expansion, the direction in which the marketplace is moving is already evident. In the future, all financial service providers will have more extensive product powers and will be able to compete across state lines.

Technology Is Driving Change

Through the computer, technology is totally changing the way we do business. It has enabled many providers to become comprehensive financial intermediaries. Increasingly, it is making networks of brick and mortar outlets obsolete. And advances in voice, data, and visual communications are providing advantages to providers who use them wisely.

Soon a network of home terminals will be in place that will give consumers access to financial information any time of the day or night. They will only need a television and a home computer to review investment data once available only to Wall Street account executives. They will be able to transfer funds, purchase stocks or other investments, buy insurance, list real estate and secure the most favorable mortgage terms, all without venturing from their living rooms.

To stay successful, providers need highly personalized, quality products that are backed with simple, straightforward financial advice. In return, the value that is added to their relationship with the consumer will help to increase customer loyalty. Where customers typically went to a dozen different institutions to obtain financial services, soon they will depend on fewer, often only one.

Banks Are No Longer Different

I have yet to mention the word "bank" in describing how the market is evolving. As far as banks are concerned, the legal framework is a barrier that prevents them from developing along the lines I have just described. They are unable to offer the products and services the public demands. The only way that banks will be able to compete is with some fundamental changes in the legal structure governing their operations.

Those changes must come quickly. The future is already upon us. The seeds of change have been planted; they have already sprouted; and it is just a matter of time before they bear fruit. Without some relief, banks will not be there when it is time for the harvest.

Banks can no longer afford to be treated differently or more harshly than other providers. Banks are unique because of the important part they play in our payments system and because they are agents for monetary control. But banks have lost uniqueness in terms of the services they can provide to the public.

While banks wait for Congress to provide them with additional powers, others in the marketplace continue to gain new competitive advantages. Sears is expanding its financial centers. Merrill Lynch is targeting small businesses for cash management accounts and loans. Realtors are selling mortgages. Grocery stores and gas stations are installing ATMs and charging the bank when the customer uses them. Everyone is selling cash

management accounts with lower and lower minimums. In fact, there is no longer a single product or service which is unique to banks—the market has developed many substitutes.

These financial services firms are offering products that previously only banks could offer. They are getting into the banking business, while trying to prevent the banks from getting into their business. It's an example of blatant protectionism, the American consumer ends up the loser. Why? Because when competition is limited, the consumer always loses.

System Can Accommodate More Competition

All of these banklike competitors can operate with fewer product and geographic restrictions than banks. They have helped to make the marketplace more competitive on a national basis and more innovative in terms of products and services. But imagine how much more competitive and innovative the marketplace could be if banks were allowed to compete. And it could be even more competitive if these other providers could own consumer banks and could offer actual banking products instead of substitutes.

Furthermore, consumers of these financial services have shown that they have no special allegiance to banks. In fact, they couldn't care less if the provider is a bank, a thrift institution, an insurance company, or a full service securities firm. What they do care about is whether they can get the products and services they want at a competitive price. If banks can't offer those products and services competitively, customers will simply go down the street to someone that can.

Need to Adapt Legal Structure

So, what needs to be done for banks to be responsive to customer demands? Banks must be free to compete on the basis of price. They must be free to offer the same products and services as other providers. They must be able to compete over the same geographic area. And banks and other providers must be regulated by function rather than by charter. To do that means changing the legal structure governing financial services.

Consumers and Small Businesses Benefit

Who stands to benefit from a change in the legal structure? Naturally all financial service providers benefit from a fair and competitive marketplace, but consumers and small businesses would be the real winners.

For instance, there would be convenient one-stop shopping for financial services. The public would be able to obtain deposits, loans, insurance, securities, and real estate services from bank holding companies, as well as from other providers.

Then, too, the menu of financial service products would be more varied. Better asset management accounts would be designed by allowing affiliations between depository institutions and securities brokers. Competition would lower the minimum balance requirements of these accounts and make them accessible to even more customers of moderate means.

The public would also benefit from new product innovations. With the ability to integrate different financial services into one package, product designers would have the freedom to creatively combine financial services in new and imaginative ways.

There would be lower costs for insurance and real estate products. Affiliations between depository institutions and insurance and real estate firms would increase competition and result in more efficient distribution systems, thereby lowering costs.

These changes would also increase the flow of credit to housing through pooling mortgages and selling mortgage-backed securities. This would make mortgages a more attractive investment and help to make mortgage interest rates more competitive.

In addition, small businesses would receive better services as a result of these changes. Providers would design low-cost cash management services for small businesses by using their ability to offer interest-bearing checking accounts and mutual fund services.

Finally, updating the legal structure governing financial services would result in stronger community institutions. By affiliating with one another, small local providers of financial services such as community banks, insurance agents, and local independent real estate firms would be better able to compete with the large financial service conglomerates like Sears, Merrill Lynch, and American Express.

A free and competitive marketplace would benefit each of us. The issue is not Sears versus Citibank or American Express versus Bank of America. The issue is whether or not the public should receive the best products and services at the lowest price, through the most convenient delivery system.

Comprehensive Legislation Is Needed

In spite of all of these benefits, some people who should know better assert that there has been too much change already. They cite the problems at Continental

National Bank, the international debt crisis, and the domestic lending problems of many of our banks. If anything, these problems clearly demonstrate the need for further changes. With more powers, bank holding companies will be able to further diversify and gain additional sources of income.

To remain strong, well-managed, and profitable, banks need broader product powers and the ability to offer them over a wider geographic area. Congress should proceed with these necessary changes as soon as possible. But if it is unable to effect the needed changes during this session, that will not diminish the need for broader powers next year. By the same token, if only limited powers are provided, we must work for broader powers next year.

The Regulatory Response

The regulatory response to the changing marketplace and economic environment has been to strongly support fair competition and the free market, while remaining tough on supervision and compliance. We have been doing this by concentrating our efforts on six specific areas.

Strengthening Bank Capital

First, we are strengthening the banking system by increasing primary capital levels. As a result, the 11 multinational banks we supervise have capital levels of 5.13 percent compared with 4.74 percent for year end 1981.

We have also been working with the Federal Deposit Insurance Corporation and the Federal Reserve Board on a plan that for the first time would require all banks, regardless of size, to have the same minimum capital levels. The 5.5 percent primary and 5 percent total capital levels that have been proposed would strengthen the banking system by adding over $5 billion in new capital to national banks over the next several years.

We feel that higher capital is necessary because of the deterioration in the quality of loan portfolios. For the same reason, we have been closely scrutinizing the banks' reserves for loan losses during the examination process. We want to be sure that these reserves keep pace with the risk in the portfolio and that management has good procedures for assessing the adequacy of reserves. And, we have also been closely looking at bank dividend policies. We will restrict dividend payouts if they are not in line with the bank's capital picture.

Supporting Increased Earnings

The second area we have been highlighting is the need for banks to strengthen their earnings position. Banks need to find ways to raise fee income, so we have authorized a number of new activities.

We have allowed them to offer discount brokerage and investment advisory services. We have permitted them to operate futures commission merchant subsidiaries, to lease space to insurance agents, to underwrite credit life insurance, and to offer plain English trusts We have also permitted them to provide common trust funds for the collective investment of IRA contributions. This action has been overruled by a recent court decision here in northern California. Even if that decision is good law, it is bad public policy. It restricts competition for IRA accounts.

Streamlining Corporate Applications

Third, the OCC has been speeding up and streamlining the application process to make it less burdensome to banks. We will continue to adopt regulations that make it easier for banks to establish new branches and ATM networks. We have already simplified the process for forming and acquiring operating subsidiaries. We eliminated or reduced the length, complexity, and processing time for many of our applications. In order to expedite the legal review process on matters involving routine banking activities, we have begun the practice of sending "no action" letters. That simply means that if we accept the facts and legal opinions presented by the bank, we send a letter stating that we have no objection to their proceeding with the activity.

Increasing Disclosure

The fourth area we have been stressing is disclosure. A proposed regulation on disclosure is out for comment now. In a competitive environment, regulators need the assistance of the market to maintain the health of the system. We have also been taking special steps to ensure the accuracy of the information we receive. That is why we now require all banks to use accrual accounting in their public reports. And recently the OCC took enforcement actions against six major banks and required them to restate some of their financial information to eliminate "window dressing" that could mislead depositors, investors, and regulatory agencies.

Improving Examination Techniques

The fifth area we have been concentrating on is improving our examination techniques. We are increasing the effectiveness of our examination staff by using new types of exams that focus on specific problem areas such as energy loans and the adequacy of loan loss reserves. And we are using technology to our advantage. Examiners now bring microcomputers right into the bank to help them during the examination

Maintaining Strict Enforcement Policy

The final area we have been giving emphasis to is the use of tough enforcement for either violations of the law or imprudent banking practices. While we're permissive on what products and services can be offered, when a bank fails to act responsibly, our policy is to come down on them like a ton of bricks.

For instance, last year we took 274 formal actions against banks compared with 156 for the previous year and only 65 in 1978. These actions have been taken against banks of all sizes. We have outstanding enforcement actions against 17 percent of the banks with assets over $1 billion and 12 percent of the banks with under $1 billion in assets. Last year, we also imposed civil money penalties against 127 bank officials. To put that into perspective, in 1981 we imposed only 19. The public demands a lot more from bank directors and bank management and so do we.

Conclusion

So we can see that changes in the marketplace and economic environment have had a dramatic effect on the regulation of financial services. Today, we are stuck with a sadly neglected legal structure meant for another time and different circumstances. Regulation alone will not make up for decades of neglect.

That is why it is of paramount importance for Congress to take up the issue of promoting fair competition in financial services. The continued viability of our banking system depends on their action. And when Congress does change this legal structure, it must hold the interest of the American consumer and the business community above that of a few protectionists with strong lobbies. The financial service marketplace must be run in the public interest, not for special interests.

Statement of H. Joe Selby, Acting Comptroller of the Currency, before the Senate Committee on Banking, Housing, and Urban Affairs, on supervision and examination policies of the Office of the Comptroller of the Currency in 1985, Washington, D.C., July 23, 1985

Mr. Chairman and members of the committee, I am quite pleased that you have called these hearings on the bank examination and supervisory process. In recent years, significant economic and technological developments have put pressure on banks' performance and on the ability of the regulators to supervise banks effectively. The environment has undergone rapid changes, and both banks and their regulators are hindered in their ability to respond to these changes. The Congress, the regulators, and the banks all have a part in ensuring that the industry has a healthy transition into the volatile, dynamic financial marketplace of today and the future. Today, I would like to discuss what the Office of the Comptroller of the Currency (OCC) is doing, and what congressional action is needed to help assure this transition. These are the views of the OCC and may not represent the position of the Administration.

Before discussing changes needed in the supervisory area, I would like to provide the committee with our views of the fundamental goals of government regulation of the banking industry and discuss why the attainment of those goals has become more difficult in recent years.

Role of Government in a Changing Environment

Without question, it is in the interest of the federal government to ensure the ongoing safety and soundness of the banking system. Banks have unique and vital roles in the payment system and in the conduct of monetary policy. To achieve safety and soundness, the government seeks to maintain a statutory and regulatory framework that promotes the long-term health and viability of the industry. The government also seeks to control risk and to ensure confidence in the banking system by monitoring the condition and performance of individual banks.

Our goal of maintaining the safety and soundness of the national banking system requires sufficient oversight of, and interaction with, bank management to minimize the likelihood of bank failure. We do not take over and manage institutions; we cannot substitute for private management in making lending or most other decisions. The primary responsibility for any bank's performance rests with its management and board of directors. However, as supervisors we do monitor risk exposure, work to see that banks have in place policies and controls appropriate to their level of risk, and enforce compliance with the law. When we identify weaknesses, we institute corrective measures and pursue their implementation. This results in significant improvement in the vast majority of institutions that we identify as having problems. For example, two-thirds of the banks that were subject to our special supervisory program in 1980 showed sufficient improvement to be removed from the program by year-end 1984.

Our bank regulatory system is not designed to prevent all bank failures. To do so would require either nationalization of the banking industry, or the elimination of all risk—one consequence of which would be to preclude banks from funding the nation's economic growth. Banks that become so weakened as to become insolvent must be allowed to disappear from the system. In such cases, our role is to minimize the impact of bank failures on other banks, on the public, on the deposit insurance fund, and on the system as a whole.

The government's ability to maintain safety and soundness has become more difficult in this decade because of dramatic, ongoing changes in the environment in which banks operate. As we and others have recounted on many occasions, economic and technological factors have put pressure on bank performance. Interest rate volatility has increased rate risk. Economic volatility and disinflation have caused a deterioration of asset quality. The necessary adoption of new technologies has created short-term cost pressures. Concurrently, competitive pressures have been intense as other financial service providers, less encumbered by statutory restrictions, have entered the banking business.

In short, the business of banking is becoming riskier and more complex. Clearly, the supervisory process must adapt to these phenomena if it is to continue to be effective. This important issue will be my focus today, but it should be noted that supervisory changes alone will not suffice. Two other areas need to be addressed if the long-term safety and soundness of the industry is to be assured.

First, as we have testified on numerous occasions, the relaxation of product and geographic restrictions should proceed if banks are to keep pace with less regulated competitors in meeting market demands. Currently, banks have only limited ability to adjust to changes in their environment. While other financial

service providers have diversified, expanded, and innovated to keep pace with new technology and market demands, banks have largely had to sit on the sidelines. New product and geographic flexibility will enable banks to meet consumer demands and make a viable transition into today's marketplace.

Second, the deposit insurance system should be restructured so that banks cannot take on risks without bearing both the costs and rewards resulting from those risks. Reform should include instituting risk-related insurance premiums which would be disclosed to the public and expose large uninsured depositors and creditors to losses when a bank fails. I do not believe that market discipline should be reserved only for subordinated debt holders (as contemplated in the FDIC's 9 percent capital proposal), while *de facto* deposit guarantees are provided for uninsured depositors.

In the remainder of my statement, I will discuss how we supervise banks, changes we are making in the supervisory process, and what actions need to be taken to address vulnerabilities in bank supervision.

The Supervisory Process

The OCC is the primary regulator and supervisor of the 4,900 national banks, with responsibility for ensuring safety and soundness and compliance with the law. OCC supervision relies on monitoring the performance of banks (through periodic on-site examinations and off-site analysis of reported financial data), enforcement activities aimed at requiring banks with problems to take steps towards rehabilitation, and public disclosure of financial information to facilitate the exercise of market discipline.

On- and Off-Site Monitoring

Our examinations have four objectives:

- to provide an evaluation of a bank's financial condition;
- to permit the OCC to appraise the quality of bank management and directors;
- to identify those areas where corrective action is required to strengthen the financial condition and management of the bank, and,
- to identify and pursue corrective action where [illegible] with applicable laws, rulings, and [illegible].

To achieve these objectives our examinations focus on an evaluation of the bank's management and its policies, procedures, and controls. It is not feasible, nor is it our role, to perform an extensive auditing or verification function in every bank. While we do limited verification, we emphasize a "top-down" approach aimed at determining the ability and commitment of management and the board of directors to comply with the law and maintain the soundness of the bank.

Resource considerations and the complex nature of the banking system require that supervision be tailored to the characteristics and condition of the bank being examined. It is particularly important that we direct our efforts to areas that pose the greatest risk or otherwise cause the greatest concern. Therefore, the OCC conducts off-site monitoring of the condition of banks to complement our on-site examinations and help us determine supervisory priorities.

Our approach to industry risk analysis illustrates this interaction. Sectors vulnerable to economic fluctuations or that exhibit structural weaknesses adversely affect the asset quality of the banking industry. For this reason, the OCC collects information on bank concentrations of credit by industry sector. Banks with significant exposure to industries with difficulties receive increased supervisory attention including additional reporting requirements and priority scheduling of on-site examinations.

After each examination a bank is assigned a rating, on a scale of 1 to 5, commonly known as the CAMEL rating. The CAMEL rating summarizes a bank's overall condition at the time of an examination by evaluating a bank's capital, assets, management, earnings, and liquidity. It is one of several supervisory tools that we and the other agencies use internally to identify those institutions that warrant a higher than normal degree of supervisory attention.

The CAMEL rating has often been misinterpreted by those outside the banking agencies as a predictor of a bank's financial condition. It is not. It is merely a rough summary of examination findings. We do not update the rating between examinations, even though off-site surveillance of a bank may indicate a change in its condition. If through such surveillance we determine an on-site examination is in order, examiners are sent into the bank. Only at the conclusion of such an examination would the CAMEL rating be changed

While the CAMEL rating system is not intended to be an "early warning system," it is a reliable indicator of the health of the banking system. Increases in the number of banks with CAMEL ratings of 3 or higher generally precede an increase in the number of bank

failures. In fact, of the national banks that failed between 1981 and 1984, 71 percent were rated 3 or worse one year before failure, and 91 percent were rated 3 or worse six months before failure.

Enforcement

The OCC has been utilizing enforcement actions vigorously in recent years to correct violations of law and imprudent banking practices. While advances in on-site and off-site monitoring techniques have been key in identifying problems, the enhanced enforcement authority Congress gave us in 1978 has improved our effectiveness enormously.

The severity of our enforcement actions largely depends on the severity of the problem. Actions range from memoranda of understanding for minor infractions or problems to cease and desist orders. In appropriate cases, our measures also involve the imposition of civil money penalties and the removal of bank officials.

We believe that we have been very successful in meeting our principal goal in the enforcement area— guiding problem banks in a way that forces actions that restore them to a safe and sound condition. Despite the dramatic growth in enforcement actions in recent years, they are not disproportionate to the number of banks requiring special attention. The number of problem banks increased from 257 in 1980 to 775 in 1984 and the number of formal enforcement actions increased from 169 in 1980 to 515 in 1984. While the public has become increasingly aware of bank failures, we believe that it is a credit to bank supervisors that a far greater number of troubled banks each year are put on the right track.

Disclosure

Public disclosure of a bank's financial condition is the third element of supervision. Currently all national banks are required by law to publish quarterly balance sheet information in a local newspaper. Bank Call Reports and Uniform Bank Performance Reports, which summarize bank performance relative to comparable banks, are available to the public through the Federal Financial Institutions Examination Council. In addition, publicly held banks and registered bank holding companies face the extensive disclosure requirements of the securities laws.

Disclosure complements our supervisory efforts by allowing the marketplace to participate in the discipline of banks. Publicly held banks are very concerned about the view that the investment community has of their condition and prospects. A downgrading of a bank's or holding company's debt, for example, would have a deleterious effect on its ability to raise funds. This acts as a powerful incentive for the bank to strive for superior performance. Also, in those cases where banks have had to disclose our enforcement actions, we have found that the bank's concern over regaining the confidence of the marketplace is an important inducement to respond to the corrective action.

Supervisory Changes

The increased risk and complexity in the marketplace in which banks operate create new challenges for both banks and regulators. The OCC has continued to meet these challenges, to the best of our ability, by adopting measures that shift the focus of our efforts toward ensuring that the banks themselves are able to manage risk. These measures address the adequacy of banks' management, their loan loss reserves, internal controls, and capital. They also include improving the means by which we obtain information about banks' activities and efforts to make management more accountable to the marketplace through increased disclosure.

Because a bank's loan loss reserve is an important line of defense against the effects of bad loans, we are paying increased attention to the adequacy of a bank's reserves, relative to the total risk in its portfolio. Where we find such reserves inadequate in comparison to a bank's domestic and/or international problem loans, we are requiring immediate additions to such reserves. That addition has an immediate effect upon bottom line earnings and often warrants a restriction of dividend payments.

A bank's internal control systems are critical to the sound management of the bank, particularly as the risk and complexity of its environment increase. Our supervision focuses on determining whether banks have adequate internal control systems that enable management to identify and control risk in the bank's operation. Examiners test these control procedures and their applications and conduct stringent followups to determine if internal control deficiencies are corrected.

The increased level of risk in the banking system clearly requires a strong capital base. I commend the Congress for enacting the International Lending Supervision act of 1983 which provided the regulators with explicit statutory authority to prescribe and enforce capital ratios. Earlier this year, under the authority of this act, the three federal banking agencies imposed a uniform minimum capital-to-asset requirement for all commercial banks. These minimums apply to well-managed banks; higher ratios are being imposed on banks with material weaknesses, and can be backed by the use of legally enforceable capital directives.

We view our recent capital regulation as an interim step toward a capital policy appropriate to a riskier environment. Since 1984, the OCC has been working to develop capital standards that would more formally recognize differences in overall risk among banks. The rather simplistic capital-to-asset ratio approach has two serious deficiencies. First, it may lead to less liquidity at banks. All assets are treated equally in the calculation of the ratio, so banks, in an effort to maintain their return on equity, have an incentive to hold higher yielding, riskier assets. We have seen banks sell high quality assets such as Treasury securities that provide relatively low rates of return and invest the proceeds in riskier and less liquid commercial loans and other assets.

The second problem with a capital-to-asset requirement is that it fails to explicitly take into consideration other risks assumed by a bank. It therefore encourages banks to shift activities off their balance sheets. Several foreign bank supervisors now include off-balance sheet activities in their capital ratios. We are concerned that proposals to further increase the capital-to-asset ratio, such as the FDIC's proposal to require a 9 percent capital ratio, are likely to be ineffective in strengthening the banking system and may even weaken it. For that reason, we believe that a risk-based capital requirement will afford the greatest protection to the deposit insurance fund.

The OCC recognizes that developing a practical risk-based capital policy will be difficult and will raise industry concerns with respect to their ability to remain competitive with other financial service providers and foreign banks. Nonetheless, we believe that this approach is a correct one and encourage industry and congressional input into this process.

Timely and accurate information concerning banks' activities is necessary to identify risks in the banking system and to better target resources to problem areas. To this end, we made a concerted effort in the 1970s to automate much of the information collected and develop a centralized database of critical information from quarterly bank Call Reports. Development of this database has facilitated more in-depth analysis of a bank's performance over time and has enabled us to identify institutions in need of special attention. To improve the quality and timeliness of our information, we plan to participate in a pilot program for direct automated transmission of Call Report information in 1986. In addition, we support the Federal Reserve Board's recent proposal to improve bank holding company reporting as a first step toward getting meaningful [illegible] data.

[illegible] approach to controlling risk within [illegible] a proposal to require banks to increase disclosure. In particular, it would extend to all banks disclosure requirements similar to those faced by publicly held banks and registered bank holding companies. We recognize the potential burden this would place on smaller banks and will weigh that against the public benefits of such disclosure. The extensive requirements faced by the larger banks have imposed substantial market discipline on them, and we expect our proposal will do the same for smaller banks. It will also enable depositors and investors to better gauge the performance of all individual banks and thus make informed decisions on where to place funds. We feel that it is important that the banks themselves, not the regulators, make the disclosures. Not only would it be expensive for the regulators to make individual disclosures for each of the 15,000 commercial banks, but we believe inordinate weight would be given to the disclosure because of its source.

Together, these changes will enhance the effectiveness of bank supervision and strengthen the banking system. Bank management and directors will have increased accountability to their shareholders, their depositors, their supervisors, and the public.

Nonetheless, our supervisory process is still vulnerable. There are a number of areas where Congress can provide us needed flexibility to make the appropriate changes. I want again to stress that these views are the OCC's and not necessarily those of the Administration.

Existing Vulnerabilities

Our supervisory approach remains vulnerable in three areas. First, banks have become subject to increased risks due to more volatile economic conditions, technological change, and increased competition. Second, fraudulent activities can be extremely difficult to detect. Third, we do not always have available the most comprehensive, up-to-date information. Things can change quickly in the banking business, yet we face lags in receiving reported data. Moreover, banks are increasingly engaging in new activities, which outpace changes in our regularly collected data.

The Congress and the supervisory agencies must work together to find ways to address these areas of vulnerability. It is critical to the safety and soundness of the banking system that the supervisory process be able to adjust to this decade's dynamic environment.

Resources

The OCC has always had to allocate resources between activities aimed at ensuring the safety and

soundness of the banking system and checking for compliance with the law. In the past two decades, however, the number of statutes requiring bank compliance have increased dramatically. Banks have had to create the new position of a compliance officer, and the regulators have devoted an increased share of their resources to enforcing these new statutes.

In the 1970s, a relatively strong and stable banking industry raised fewer safety and soundness concerns and enabled the OCC to emphasize compliance. More recently, however, a dramatic increase in the number of banks requiring special supervisory attention has forced the redirection of resources toward the evaluation of the financial performance of banks. While we obviously have not been able to accomplish 100 percent of everything, we are satisfied with the way we have balanced our priorities.

Our ability to effectively supervise national banks is dependent on our having a cadre of experienced capable examiners. The OCC has devoted millions of dollars in recent years on training programs and new supervisory techniques (such as increased use of microcomputers) in an effort to meet its responsibilities. Fortunately, our examining staff is composed of bright, dedicated, and hardworking individuals who are willing to serve in the public interest with little recognition of their good work. But this self-sacrificing service cannot be expected to last forever.

Our biggest, and most critical problem, therefore, is our inability to retain the quantity and quality of experienced personnel required to examine and supervise banks. Once hired, new entrants are provided with extensive training. It takes approximately five years of training and apprenticeship for a new hire to become a national bank examiner.

Unfortunately, the long-term compensation prospects for trained agency personnel do not compare favorably to those of the banking industry. As a consequence, a number of mid-level and senior examiners leave every year to join the banking industry. The agency's turnover rate of 14 percent is well over four times that of the federal government as a whole. While this is obviously a tribute to the quality of OCC examiners, it places a heavy burden on remaining examiners and severely limits our ability to undertake the examination effort we think is required. To remedy this problem, we need to be able to offer salaries competitive with those offered in the banking industry. Until this is done, the limits on compensation of government employees make it impossible for us to retain the number of qualified personnel required.

An additional burden for examiners and another impediment to effective bank supervision is the absence of absolute immunity for examiners from civil damage suits that seek to impose personal liability. The threat of potential litigation has a chilling effect on the action of bank examiners. Effective bank supervision requires examiners to make difficult judgments. The personal savings of examiners should not be subject to potentially harassing litigation for making these judgments. We support legislation presently pending that would provide this protection to all federal employees.

We have also experienced a drain on resources due to increased litigation. First, there has been a substantial increase in private litigation involving national banks. Even though this office is not a party to such litigation, we are being inundated with discovery requests from litigants seeking reports of examination, examiner workpapers, correspondence files, and examiner testimony for use in such litigation. This office expends a disproportionate amount of resources objecting to, defending against, and responding to such requests. We would request that Congress grant us relief from this burden by statutorily placing this information beyond the reach of civil discovery in cases in which this office is not a party.

The OCC has also incurred substantial costs in investigating and litigating abusive insider cases. To facilitate an aggressive enforcement program, consideration should be given to permitting us to impose penalties sufficient to cover the costs of investigation and litigation.

Information Needs

As noted earlier, the agency relies heavily on its ability to obtain accurate and timely information on a bank and its activities. Detecting fraud in financial institutions is difficult even under the best of circumstances. Moreover, a number of barriers to cooperation among law enforcement officials have been erected. The Right to Financial Privacy Act of 1978 (RFPA), grand jury secrecy rules, and other state and federal privacy laws all impose certain impediments. We support the overall objective of those statutes and rules, but have found that they unduly restrain government information gathering and the free flow of information among agencies.

For example, the RFPA has limited our ability to coordinate with other federal agencies. In addition, the rigid rules under which grand jury information may be made available for use in the preparation of civil enforcement activities has, in some instances, prevented us from receiving information that may have been useful to remove officials or prevent a change of ownership. In addition, under those rules, examiners who participate in a grand jury investigation are precluded from using the information they receive for regulatory purposes

and may even be disqualified from participating in future civil regulatory activities involving the subject matter of the grand jury investigation. I urge Congress to examine these statutory barriers to interagency cooperation and to consider how those impediments might be reduced without seriously compromising the important interests they were intended to preserve. The Administration has introduced legislation, which we support, that addresses some of the difficulties imposed by the RFPA.

It is absolutely essential that we have the ability to obtain accurate and timely information to fulfill our supervisory responsibilities. During a time of economic fragility and rapid change, adequate and timely information is the keystone of our supervisory structure.

Another barrier to our ability to obtain adequate information is the lack of protection afforded bank "whistle blowers." The OCC requires national banks to report suspected criminal acts. Individuals who come forward to do so may be subjected to possible retaliation by the bank or its officials—particularly where they may be reporting the suspected criminal acts of their superiors in the bank. To provide such individuals with some form of legal protection, consideration should be given to creating a specific federal right to sue for wrongful discharge.

Flexibility Needs

A particularly troublesome constraint faced by the OCC is the lack of flexibility we have been given to deal with problem banks. When a bank is identified as having serious financial difficulties, and we have exhausted all the usual means to correct the situation, our ability to require major changes in an open bank's operations or management is limited. Typically, it is not until a bank's capital or liquidity is exhausted that a regulator can step in and merge a weak bank with a strong bank.

There are several approaches to dealing with this problem. First, incompetent management must be removed before irreversible damage is done to the bank. Of course, the primary responsibility for replacing management rests with a bank's board of directors. However, for those instances where a board of directors is unwilling or unable to exercise its responsibility to provide sound management, it is necessary for regulators to have adequate authority to deal with problem management.

Under current law, the procedures for removing management are cumbersome and the standards are difficult to meet. Legislation has been proposed by the Federal Deposit Insurance Corporation (FDIC) and the Federal Home Loan Bank Board (FHLBB) to address some of the problems. We believe it would be appropriate to revisit the existing laws in this area to increase the regulators' flexibility to deal with ineffective management.

Another approach to dealing with problem institutions, and reducing the cost to the public and the FDIC of a bank failure, would be to respond earlier and more forcefully to problem institutions. If a bank could be closed at exactly that point when the owners' capital had been exhausted, then in theory neither the FDIC nor other creditors or depositors would suffer a loss. Unfortunately, imprecise measurements of the market value of a bank's assets and our inability to close a bank prior to its reaching a point of book insolvency (except in the case of a liquidity insolvency) generally result in failed banks having capital deficiencies. In other words, by the time the regulators can close a bank under existing policy, the market value of the bank's assets are usually less than the outstanding claims against the bank by its depositors and general creditors. As a result, either the FDIC and/or the creditors and depositors suffer a loss.

Such a loss could be minimized if the regulatory agencies were provided with expanded authority to deal with open banks determined not to be viable over the long-term. For example, a policy could be adopted that any time a bank's capital falls below 3 percent (the level at which the FDIC generally considers termination of deposit insurance), the primary supervisor would be given the authority to require the owners to seek a merger partner or to liquidate the bank. Alternatively, a conservator could be appointed by the primary supervisor with authority to exercise the full range of powers possessed by bank management, including the sale of the bank.

To implement such a policy, the OCC needs additional operating flexibility under the Bank Conservation Act. We are currently researching what other changes, if any, would be required. We would be pleased to work with the committee in exploring this idea further.

More flexibility is also needed in the handling of closed banks. In particular, there are instances where state branching restrictions impede dealing with a failed bank by discouraging bids by out-of-state holding companies. The extraordinary acquisition provisions of the Garn-St Germain Depository Institutions Act of 1982 should be expanded to allow an out-of-state holding company that bids to acquire a failed bank to acquire the entire holding company of that bank and not just the bank, as is currently the case. Such an amendment would remove the disincentive for out-of-state holding companies to bid in those states that restrict branching but permit multiple-bank holding companies.

Finally, we do not have sufficient flexibility to deal with changes in bank control. Under the Change in Bank Control Act, we cannot impose conditions necessary to ensure safety and soundness as we can when we charter a new bank or approve a merger. We can only disapprove notices and must do so within unreasonably short timeframes. In addition, we lack adequate investigative authority. We believe legislative action is required to provide us increased flexibility under the act.

Conclusion

Mr. Chairman, this is surely one of the most challenging periods the banks, the supervisors, and the Congress have ever faced. You have a unique opportunity to address the major policy issues that are prevalent in today's financial environment, and to thoughtfully legislate solutions that will provide the American citizen with a strong and responsive financial system.

We must work together to take a comprehensive approach. As you have recognized, the issues are neither singular nor free-standing. We must make progress on three fronts. As banks gain the necessary flexibility through deregulation to meet marketplace demands, the roles of deposit insurance and supervision must also be reviewed. The reform of the deposit insurance system must have as its goal the encouragement of public confidence in the banking system and the furtherance of market discipline. Finally, supervision must adapt to the increased complexity of the financial system by acquiring the necessary tools to better anticipate and deal with emerging problems.

We now have the opportunity to formulate and implement important reforms of the financial system. It will not be an easy task, but let us not forget that the continued health of the banking system, and the role it plays in our nation's financial and economic life, is at stake.

Remarks by Robert L. Clarke, Comptroller of the Currency, before the Assembly for Bank Directors, on the duties and responsibilities of bank directors, Banff, Alberta, Canada, September 6, 1987

Tomorrow is an important anniversary in U.S. banking history. On September 7, 1876, a gang of bank robbers headed by Jesse and Frank James was decimated in a famous raid on the First Bank in Northfield, Minnesota. The citizens of Northfield cut off the gang's escape after the robbers inadvertently alerted the town by shooting a bank clerk for not opening a safe. Jesse and Frank James got away, but their associates were wounded and captured. Ironically, the safe wasn't even locked.

By your invitation, I'm here today to talk about how the Office of the Comptroller of the Currency (OCC) views the duties and responsibilities of national bank directors. In a nutshell, our perspective is this: if the bank hit by the James Gang in Northfield, Minnesota, had been under OCC supervision, it would have been the responsibility of the bank's directors to ensure that the safe was locked. But I'm sure the directors would have argued that that was a management function.

Fortunately, few banks will ever face a threat as immediate, unexpected, and life-threatening as a raid by organized, professional, seasoned outlaws.

But while the threats most banks may face are far more mundane, they may, in the end, be just as devastating. Any bank can be brought down if management is incompetent or if it engages in insider abuse. Any bank can be cut down if the institution fails to plan for the future. Any bank can be worn down if the need for internal controls or the vital signs that measure business performance are ignored.

It is the responsibility of the national bank director to ensure that management is competent, to ensure that management refrains from insider abuse, to ensure that the institution has internal controls and that it plans for the future, and to monitor the institution's business performance.

If this sounds a lot like my own job description as Comptroller of the Currency, there is a good reason. As I see it, this morning I am talking with a group of colleagues. In the words of former Canadian Prime Minister Arthur Meighen: "We are not in the same boat, but we are in the same waters."

Bank supervision works on two levels. On the first level, owners have a responsibility for supervision, a responsibility focused, understandably, on their own bank. Then, on the second level, there is supervision by regulators, whose responsibility is to the banking system.

The things the regulator looks for in a bank—healthy financial condition, managerial skill and rectitude, and so on—are also the things that logic would lead us to believe the owners would also desire and demand. As owners and as representatives of other owners, then, bank directors have a powerful incentive to supervise the institution in their charge. That incentive is your own self-interest.

Your self-interest in protecting and enhancing the owners' investment in your institution, the banker's interest in running a strong and profitable institution in part to please you, and the supervisor's interest in maintaining the safety and stability of the banking system are three different motivations. These three motivations, however, should prompt the director, the banker, and the bank regulator to act together, to act as a team, and to achieve the same goal: a stronger institution.

To stretch this imperfect analogy a bit more, the board of directors has several roles to play as part of the team. At times, it must play the defensive line. At times, it must be the coaching staff. It also writes the play book. And, as representatives of the owners, the board recruits the star players, senior management, and negotiates their contracts.

In short, the OCC views the board as an integral part of any well-managed institution. As bank supervisors, we want to help directors play each of these roles, and others, so that we are all a part of a winning team. But bank supervisors cannot play the directors' role for them.

We have our own role to play. As I said before, our focus is on the banking system as a whole. And, in recent years, we have had to concentrate on this focus even more as banking becomes more complex and the number of problem banks grows greater.

At the same time, our banking supervision has never been a substitute for the supervision directors should provide. The simple truth is that bank supervisors are not, and have never been, the guarantors of the financial health of the individual institution. We are not, and have never been, shadow management for individual institutions.

It is management's job to run the institution, and good managers will run the institution as if there were no bank supervisors to provide a backstop. Furthermore, it is the director's job to assure that management approaches its job as if a backstop didn't exist.

As a former bank director myself, I know that being a national bank director can be a satisfying and rewarding experience. From personal experience, I know that few jobs carry as much prestige in thousands of communities across the country. But, from personal experience, I also know that to meet the duties to the institution, to its stockholders, to its depositors, and to the public at large, a director must be knowledgeable and active.

At the OCC, we recognize the important contributions knowledgeable and active directors make to the bank and to the community. We appreciate just how much directors can enhance the safety and soundness of the banking system. And we want to support directors by ensuring that they, and that includes all of you, have a clear idea of what is expected of them.

We have, therefore, spent the last year preparing a book for national bank directors to provide in-depth, practical guidance for meeting the duties and responsibilities of the job. This book, *The Director's Book, The Role of a National Bank Director,* outlines the responsibilities of a board, highlights areas of particular concern, and addresses in broad terms the duties and liabilities of the individual director.

We hope that this book will make the director's job easier and that, as a result, directors will feel more comfortable and more effective in meeting the demands the job places on them. In broad terms, the book discusses the role of the board of directors in a national bank, the board's responsibilities, the director's individual responsibilities, a director's legal liabilities, and supervisory enforcement actions.

For the rest of my time this morning, I would like to touch on the major expectations the OCC has of national bank directors, expectations stressed in the book.

First of all, we expect the board to ensure competent management. Quality management is perhaps the single most important element in a profitable and soundly run bank. The quality of a bank's management may mean the difference between success and failure in difficult economic times, and its importance grows as banking institutions face the stresses of an increasingly competitive marketplace. Therefore, the board's responsibility for selecting and retaining management may be its most important responsibility.

If it is, it is followed closely by the responsibility of assuring that management continues to act competently and honestly. The board controls the bank's direction and determines how the bank will go about its business. The board establishes the policies under which it will operate. The board may delegate day-to-day operations to management. But the board remains accountable for making sure these operations are carried out in compliance with law and regulations. And that these operations are consistent with safe and sound banking practices.

We expect directors who are faced with management actions that break the law or that are unsafe and unsound to follow the Nancy Reagan response to drug use: "Just say no."

In other words, we expect directors to be independent and actively involved in the bank's affairs, even when it means conflict with management. . . or rather, especially when it means conflict with management. If a bank needs more potted plants, it can buy them. The board of directors shouldn't just provide decoration.

Using the same standards of independence and action, we expect directors to ensure that the bank has plans and policies appropriate to its market situation. Planning for a small bank in a static environment can be a relatively simple process of defining its basic business and setting goals. But in a changing and competitive environment, the kind where most banks operate, effective planning becomes more complex and more critical to success. Only by knowing what the bank is and what it wants to become can the board know whether it has the resources and capabilities to reach its goals.

The planning process should begin with the development of a long-range plan. Then short-term business plans should translate goals into action. As for planning, the board is responsible for defining for its bank what banking practices and levels of risk are acceptable.

All major activities must be covered by policies, and before any new activity is begun, policies and procedures must be in place. Policies should be written. They should be reviewed at least annually. And they should work. Just having a written policy in the file is no good if it isn't used or if it doesn't work.

We expect policies to be in place for loan portfolio management, loans, loan review, funds/asset liability management, management information systems, contingency funding, investment, and trust activities. In addition, we expect to see codes of ethics and policies on conflicts of interest.

I would like to emphasize, also, that management information systems are extremely important. Effective funds management and a bank's ability to provide competitive and profitably priced products to its customers rest on the ability to integrate and analyze data from different parts of the bank's operations.

The board should insist that management information systems be adequate to ensure accurate and timely reporting, coordination and control of all funds management activities, both on and off the balance sheet. The board should also make sure that support system changes are in place before new activities are undertaken.

Three rules of thumb apply here. You have to know where you are to know where you're going. If you don't know where you're going, any road will take you there. If you don't know where you're going, you may find yourself where you don't want to be.

These rules of thumb also apply to the issue of adequate control. The board is responsible for ensuring that bank management has incorporated a sound system of internal controls into the bank's day-to-day operating procedures. Internal controls are designed to safeguard assets, to ensure accuracy and reliability of data, to ensure compliance with policies and applicable laws and regulation, and to promote management efficiency. They include such basic precautions as ensuring that duties are properly separated and verifying accounting data.

While a board can monitor day-to-day operations through management reports, it must do more than merely accept and review these reports. It must verify their accuracy and reliability. At the OCC we believe that a board can best meet these oversight responsibilities through a comprehensive audit and control program that provides a focus on control issues and a periodic review of all aspects of bank operations.

Finally, I would like to touch on the last area of board responsibility I want to talk about this morning: business performance. We don't expect directors to be financial analysts. But we believe they should know enough to be able to discern poor operating performance, poor asset quality, and poor funds management techniques. They should evaluate performance both against the bank's own targets and against the performance of its peers. We recognize that there are not model ratios or numbers that guarantee success.

Rather, a board needs solid financial data and analyses which can answer questions such as: Is management meeting the targets established in its own planning process? If not, why not? Was the plan unrealistic in light of the circumstances? Is the level of earnings consistent or erratic? Do earnings result from planned implementation of bank strategies or from quick earnings gambles? Are earnings figures accurate or do they result from incomplete evaluation of asset quality or expenses?

Directors should identify what information they want to see, and how frequently, and request that management provide those reports to them.

To meet all of the responsibilities I just outlined, as well as others discussed in our new book, the individual director must gain a basic understanding of banking as a business, banking as an industry, and bank laws and regulations. To meet these responsibilities, the individual director must be diligent in performing the job. That means attending board and committee meetings, requesting and reviewing meeting materials, asking questions and requesting explanations, and being familiar with audits and supervisory communications. To meet these responsibilities, the individual director must exercise independent judgment, and must be loyal to the bank's interest.

We don't expect bank directors to be insurers or guarantors of the bank's profitability or of management's conduct. We don't expect bank directors to be all-knowing in the business decisions of the bank. We do expect bank directors to be diligent in carrying out their responsibilities. And we do expect bank directors to use judgment. We are not looking to directors to be in-house police forces or scapegoats for poor managerial decisions. But we are looking to directors to be directors—and a director must direct or suffer the consequences of failing to direct.

In the February 1882 issue of the *North American Review,* Comptroller of the Currency Edward S. Lacey published an article titled, "Can Our National Banks Be Made Safer?" In the ornate language of the day, Comptroller Lacey wrote: "To provide against injudicious banking and defalcations, directors should exercise greater diligence and attention in instructing and supervising officers."

That was the OCC perspective 95 years ago. That is the OCC perspective today.

As great as our expectations are, they fall far short of directors managing or policing a bank. Rather, taken together, they are intended to motivate bank directors to bring insight, interest, and involvement to the board, so that the board itself will be an independent source of safety and soundness for the institution and, in turn, the banking system of which it is a part.

The reasoning is simple. Outside directors tend to be successful people in their own right: entrepreneurs,

managers, professionals, experts. They tend to be people with a wealth of talent and experience.

If brought to bear in a bank's boardroom, this talent and experience can be a great intangible asset for the institution. If tapped, this talent and experience can help anticipate problems, prevent them from arising, and make their solution easier when they do arise.

As you can see, bank supervisors have a simple interest in promoting the use of that talent and experience in the boardroom. Directors who bring their insight, interest, and involvement to the boardroom strengthen the bank.

In short, we bank supervisors expect directors to take their job as seriously as we take our own.

When the James gang raided the First Bank in Northfield, Minnesota, 111 years ago tomorrow, the strength of a bank, in one sense, was measured by a safe that was secured. Today things are more complex. The safety and soundness of a bank—and the banking system—in large part rests not on iron boxes and strong locks, but in your hands and in the hands of your bank director colleagues.

It rests in your knowledge. It rests in your effort. It rests in your judgment.

We at the OCC hope that our new book will be an "exercise manual" for directors throughout the national banking system, a "how to" guide to increase your knowledge, to intensify your effort, to sharpen your judgment. We want to help you strengthen your grip on the job.

Statement of Robert L. Clarke, Comptroller of the Currency, before the Examination, Audit, and Review Task Force of the House Subcommittee on Financial Institutions Supervision, Regulation, and Insurance of the Committee on Banking, Finance and Urban Affairs, on supervision and examination policies of the Office of the Comptroller of the Currency in 1989, Washington, D.C., March 22,1989

Thank you, Mr. Chairman. I appreciate the opportunity to testify before this task force on issues of fundamental importance to the Office of the Comptroller of the Currency (OCC): bank supervision and compensation. Bank supervision is our job. We cannot do our job unless our people are sufficiently experienced and adequately compensated. My written testimony addresses the experience and compensation issues in detail. It answers all the questions you asked us in your invitation letter.

That written statement, I believe, makes an airtight case for establishing compensation parity among all the depository institution supervisors, and I recommend it to you. We also appreciate your concern about his issue and your support. In my testimony this afternoon I will focus on the first issue, bank supervision.

Bank supervision exists, Mr. Chairman, for two reasons: to protect the depositor from loss when an individual institution experiences problems and to protect the depositor from loss should the financial system experience problems. It isn't the goal of bank supervision to protect stockholders and managements. They have the right to succeed, and to fail, in a free enterprise economy. But the failure of an individual institution should not bring the system down, or injure the average depositor, or produce big losses to the deposit insurance fund.

Bank supervision keeps these things from happening.

In your invitation letter you asked me to describe how often we examine banks and what our process entails. To answer those two questions adequately, I must first describe our approach to supervision and why we take the approach that we do.

The OCC supervises 4,319 federally chartered banks having total assets of approximately $1.8 trillion. Although national banks number only about a third of the banks in the country, the remaining two-thirds being state-chartered, national banks represent about 60 percent of the total assets in the U.S. banking system. Most of the nation's largest money-center banks are federally chartered. And many of the larger regional banking institutions are federally chartered, too.

The OCC believes that the national interest requires a safe and stable national banking system, a national banking system that preserves public confidence, a national banking system that makes available a wide variety of financial services in a competitive marketplace.

Supervision is essential to assuring this safe and stable national banking system. And this supervision requires striking a balance between allowing banks the maximum degree of flexibility to provide innovative services and ensuring that such services are delivered in a safe and sound manner. Overly strict regulation would stifle creativity and competition. Too little supervision would promote an unsafe system that could jeopardize public confidence.

We cannot and should not manage banks day-by-day. The responsibility for ensuring that an individual bank's safety, ability to compete, and compliance with banking law rests with the banking directors and management. The OCC, however, is responsible for promoting the safety and soundness of the banking system. And we do so by requiring that national banks adhere to sound management principles and that they comply with the law. We do so by encouraging banks to satisfy customer and community needs while remaining efficient competitors in the financial services market.

To accomplish these overall objectives, we approach supervision from two directions: supervision of the system and supervision of individual institutions.

First, in supervision of the system we analyze information from individual banks and the financial marketplace to identify issues that will affect the system, to project the impact of these issues on individual banks and groups of banks, and to take steps to minimize any harm.

For example, last year we completed and released a major study on the causes of bank failure. Later, we

The written statement and responses to questions relating to the OCC's hiring practices have been omitted. See volume 8, number 2 pages 51-61 of the Quarterly Journal for the complete testimony

looked at highly leveraged transactions at national banks analyzed that market and issued guidelines to examiners that we hope will prompt banks involved in highly leveraged transactions to devote more attention to safety and soundness standards We also analyzed real estate markets, detected some softening in the markets looked at major bank participants in real estate lending made suggestions on how they could improve their performance, and communicated these suggestions more broadly to all banks.

In supervising individual institutions, we begin by monitoring individual banks. We analyze information, both at the bank and in our offices, identify weak or problem areas in the bank, discuss these problems with the bank's management and board of directors, and develop specific plans for correcting the problems. Generally, the OCC is able to work cooperatively with bank management and the board of directors to resolve problems. But if this cooperative approach doesn't work, we use administrative or enforcement actions.

We view the supervision of individual banks as a continuing process. We tailor our approach to the individual bank's characteristics and risks. We monitor their condition to track, among other things, fast growth, rapid declines in earnings, and, on a broader level, adverse trends in markets. Our focus is on the early identification of problems and their causes, followed by a prompt, effective, response to resolve problems. In addition, we also seek to prevent problems from developing.

To that end, the OCC strongly encourages banks to develop management systems and controls to ensure that management recognizes problems at an early stage and takes corrective action, a discipline that is in place all day, every day.

Mr. Chairman, we don't see our primary role as that of being bank police. To be sure, where we find banks breaking the law, we act. But our fundamental approach to safety and soundness for the vast majority of institutions that are in compliance with the law goes beyond merely imposing commandments and checking to see that they are followed, in other words, after the fact supervision

We also want to be a positive force in creating a better banking system in advance And a better banking system requires better bankers. Through our analysis, we show bankers how to avoid and minimize problems And we prompt them to adopt and use managerial [illegible] improve their performance. We are [illegible] "Thou shalt not" We are also [illegible] that if you do this, this [illegible] commandments that we act like police, we are police But in most cases we are analysts bringing our knowledge to bear on preventing problems and improving performance, not ferreting out malfeasance and punishing it.

That being the case, how do we allocate our resources? We try to provide each national bank with the amount and degree of supervision that we believe necessary:

- To keep the OCC on top of existing and potential problems in the system and at individual banks.
- To monitor every national bank's financial condition and to analyze that condition at least once every year.
- To create a supervision strategy that addresses individual bank problems and that provides for effective resolution and corrective action.

Of course, some banks require more attention than others for these objectives to be met. So the amount of supervision each national bank receives varies according to our assessment of risks posed by individual banks or banking activities to the safety and soundness of the banking system as a whole. Our assessment of risk is based on the potential impact of an issue or institution on the system, the size of an institution, and the seriousness of its problems.

We develop a specific supervisory strategy for every national bank, a strategy that takes into consideration such factors as the quality of management; scope of operations; adequacy of policies, procedures and planning; internal controls, audit coverage and problem loan identification systems; overall financial performance; and any other factors that might affect the condition of the bank.

How does all this work in practice?

We keep examination staff on full-time duty at 11 of the country's largest national banks. Together, these 11 multinational banks, and their banking affiliates, account for about 35 percent, more than a third, of the assets in our national banking system. Our continuous presence provides us with greater knowledge of the day-to-day managerial decisions at these complex institutions than would otherwise be available. In doing so, it increases our sensitivity to the general condition of those institutions. The examiner on duty at the 11 multinational banks routinely stays in touch with the OCC's Washington office This on-site monitoring program has increased our predictive capability in the supervision of the nation's largest banks and has quickened our response to problems

Banks with more than $1 billion in assets other than the multinationals, banks that we call regional companies, have an examiner assigned who routinely checks them out once a quarter. These 160 or so national banking companies account for about 47 percent of the assets of national banks. For the other national banks, examination strategies are developed by an examiner, called the portfolio manager, who has been assigned responsibility for the continual supervision of the bank. These strategies blend on-site and off-site analyses. We expect the portfolio managers to be thoroughly familiar with the condition and activities of their banks at all times.

The supervisory process they follow is composed of four parts: information gathering, analysis, communications, and problem resolution.

We gather information from a large number of sources. These include: on-site reviews of bank records and systems and discussions with bank management and employees; bank reports required by law, such as call reports; specific requests for information; bank management information, such as board reports, information learned from applications submitted in connection with corporate requests; and so on.

Examiners analyze this information, as well as bank activities and systems, to determine actual and potential risk.

The results of our supervisory efforts and concerns are communicated to the bank's board of directors and management of a bank orally and in writing through discussions with bankers, meetings with the board of directors, reports of supervisory activity, handbooks, banking circulars, banking bulletins, advisory letters and so on. Finally, problem resolution includes actions that range from increased supervision and contact with the bank to enforcement actions. The focus of such action is to correct the causes of problems and to ensure that the bank establishes procedures to prevent their recurrence.

Because of the way we supervise banks, a meaningful measure of the amount of supervision we perform is the average number of workdays we allocate to banks. On average, our examiners spent more than 1,950 workdays on each multinational company and 492 workdays on each regional banking company in 1988. Workdays allocated to community banks, those below $1 billion in assets, were in direct correlation to the bank's financial condition. As you know, Mr. Chairman, we rate the financial condition of banks under our supervision on a scale of 1 to 5, with the healthiest being rated "1" and the most troubled being rated "5."

Last year, OCC examiners on average allocated 135 workdays to each bank rated "5," 93 workdays to each bank rated "4," 68 workdays to each bank rated "3," 43 workdays to each bank rated "2," and 25 workdays to each bank rated "1."

Mr. Chairman, the OCC also follows a systemic approach to ensuring compliance with laws and regulations. In other words, in addition to compliance targeted in bank-by-bank supervision, we review adherence to banking law in a random sample of community banks each year, about 16 percent of such banks. All multinational and regional banks are reviewed for compliance every two years.

Examiners assess bank procedures and systems for ensuring legal compliance, as well as the bank's actual compliance with law. Banks in the review sample are required to correct violations and make any necessary improvements in their systems for ensuring compliance. In addition, the results of these reviews allow the OCC to assess the level of compliance throughout the banking system and to alert all national banks to problem areas. Mr. Chairman, it's very difficult to describe what the OCC does in a 10-minute overview, but I think I've hit the high points. I welcome your questions.

Remarks by Robert L. Clarke before the Consumer Bankers Association on supervision and examination policies of the Office of the Comptroller of the Currency in 1991, Hot Springs, Virginia, September 23, 1991

. . . [T]he last few years have been difficult ones for bankers and bank regulators.*

At times, I believe many of us on both sides have felt a lot like the passengers on an airplane that, some years ago, was flying to Britain when the captain's voice came through the address system and said: "Attention, this is the captain. Those of you on the starboard, or right, side of the aircraft can see that the engines are on fire. That is why the aircraft is losing altitude."

"Those of you on the port, or left, side of the aircraft can clearly see a small, orange dinghy bobbing about on the sea," the captain said. "I am speaking to you from that dinghy."

We — bankers and bank regulators — have been rocked by the turbulence in the economy — and the consequent turmoil in the banking system — over the last several years. We really weren't in the same boat — but one might say we were peering out the same side of the airplane. Once the shock of the view wore off, it was only natural to ask: "Was there anything we could do?"

With some exceptions, the good news was that, yes, there was.

We could get — and keep — the situation under control.

But doing so required a reassessment. A reassessment by bankers of what businesses they wanted to pursue and how they wanted to pursue them. A reassessment by bank regulators of how best to promote the safety and soundness of the banking system.

To a great extent, the bank regulatory issue of the 1990s will be — indeed, it has already proven to be — how best to make sure that the problems of the 1980s don't occur again. What could we at the OCC do to prevent these problems from occurring again — or, at the very least, what could we do to reduce problems to the lowest possible number?

We began our reassessment more than three years ago — when we surveyed the damage wrought by the banking crisis in Texas. Where we've headed since then offers the best guide to where we are going in the future.

In our reassessment — and the actions we have taken that were prompted by it — you can see the future course of bank regulation appearing like the outlines of a developing photograph.

To understand our reassessment and the actions arising from it, it is necessary first to consider banking and its environment in the 1980s, and how a number of elements came together. The economy — for the most part — was expanding. Employment grew. Much of this expansion happened in the service sector. This created an impetus for building office space and other retail space. Lenders of all types — banks, insurance companies, savings and loans, pension funds — jumped in to lend. The result was that too much was built too quickly — by one estimate, 48 percent of all commercial real estate in the United States was built in the 1980s. Even good projects were endangered by this overbuilding — and a huge buildup of debt occurred across the board.

In 1987, we at the OCC began to see troubling conditions in some real estate markets outside Texas and took a close look at the condition of real estate loans at banks.

The OCC's concern over the high level of national bank investment in real estate became public in 1988 — after we conducted special examinations in a group of large regional banks with big real estate exposures. I delivered a speech discussing those concerns in detail — a copy of that speech was sent to every CEO of every national bank in the United States. That speech was followed by more real estate exams at larger banks. And these were followed by stepped up annual asset quality exams at all large banks.

The purpose of these examinations was simple and clear: To prompt bankers to make a realistic assessment of the value of their loans — and to take losses — and to build reserves where appropriate

As many of you know, this year we are thoroughly examining all banking companies with assets in excess of $1 billion — banks which together account for 80 percent of the assets in the national banking system — and all problem banks. We did the same thing last year. And we are assessing the condition and meeting with

*Portions of this speech have been deleted. The unabridged version is in volume 10, number 4, pages 13-16 of the Quarterly Journal

the boards of directors of all national banking companies, big and small institutions alike, annually.

It was understandable that our efforts brought howls and protests from some bankers and some customers who were faced with making reassessments of their own. As we all saw in the Southwest and farm belt experiences earlier, such reaction is inevitable when economic prosperity comes to an end. I've talked to bankers and borrowers who were affected. I know how they feel. I know it is never easy.

...

The criticism that we've received for being too tough has been exceeded only by the criticism that we've been too lax.

In that regard, I must mention one other factor that played a role in the story of banking in the 1980s. The deposit run at Continental Illinois in 1984 showed just how large a systemic risk the possible failure of a large bank posed. The Continental experience also showed conclusively that the failure of a large bank could cause serious problems in many small banks through the loss of their correspondent balances.

In response to that experience, the OCC in 1984 and 1985 developed a supervisory process that would focus our resources on the largest institutions in the national banking system and on those other areas of risk throughout the national banking system that represented the greatest exposure.

We focused on the large banks because that was where a lot of the systemic risk was. And that is where a lot of the systemic risk is today.

Small national banks had, up until that time, a history of stability. During the 1970s and early 1980s, the condition of small banks did not change appreciably between examinations.

Looking back with the clairvoyance that the passage of time provides, the OCC could have devoted more attention to small banks.

In the future, we will.

Next year, we will continue our policy of conducting annual examinations of banks with assets in excess of $1 billion and of all troubled banks.

In addition, over the next two years, we will begin examining highly capitalized small banks on an 18-month cycle.

To meet that schedule, we must hire about 300 new examiners — thus increasing our field force by about 15 percent.

Of course, this is what the Administration's legislative proposal would require us to do -- and our support for that proposal is clear from our taking action before we are required to.

Do we expect these actions to eliminate all small bank failures?

No.

Despite the best efforts of regulators, banks that are exposed to local economies are going to suffer a great deal when the economies in which they lend turn downward.

And some of them will fail.

But more frequent examinations will give us better information about small banks. And better information will promote more effective supervision.

Just briefly, I will touch on a few of the other actions that have arisen from our reassessment in the wake of the high rate of bank failures in the Southwest.

In 1988, we completed a study of national bank failures that demonstrated that the quality of bank management almost always spells the difference between success and failure when a troubled bank operates in an economic downturn. As a result, we have intensified our focus on bank management practices and intensified our testing of internal control systems to be sure they work. In 1989, we adopted new supervision guidelines to review the quality of bank management.

As I noted before, the OCC began in 1988 to alert banks to the risks of excessive concentrations in real estate lending if bankers had not devoted sufficient attention to sound underwriting standards. We again pointed out deficiencies that our earlier examinations had disclosed.

In 1988, we also distributed the first federal bank examination guidelines for evaluating the risks of highly leveraged transactions. These guidelines were followed by full scope examinations with special emphasis on HLTs.

In 1989, we adopted a closure rule under which we close a bank when its equity capital is exhausted. As you know, the previous policy was to close a bank when it exhausted its primary capital, including its loan loss

reserve. Since 1989, the current rule has saved the insurance fund significant dollars.

Over the years, the OCC lost many of its best and brightest examiners to the other banking agencies, which could pay them higher salaries. To deal with that problem, we worked with Congress to establish a compensation program that would be competitive with those of our regulatory counterparts — and, now that the program is in effect, we have lowered our turnover rate significantly.

Over the past few years, we have expanded the capacity of our financial analysis to detect signs of deterioration and other concerns in the economy and in the banking system earlier. This improvement gave us an early warning of problems in HLTs and real estate lending in 1988.

And we have significantly increased the number of enforcement actions to ensure bank management's follow-up on problems that we identify. Formal and informal actions increased from 316 in 1988, to 415 in 1989, to 559 in 1990. We are bringing more enforcement actions against people, instead of institutions. And in some cases, we have sought the removal of bank managements.

All of our efforts focused the attention of senior bank managements on their problems. If the banking system had continued in the direction it was heading in the mid-1980s, the system simply would not have survived the inevitable disaster.

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To avoid any misunderstanding of our actions and intentions — so that everyone will get the message — I will be outspoken, frank, and direct this morning.

Though some of the details are still developing, the outlines of bank regulation in the 1990s are clear. They are clear in the actions that the OCC has taken. They are clear in the actions we intend to take in the future.

Regulation has become closer — and it will continue to be. Closer attention will continue to be paid across the board.

Earlier intervention by the regulatory authorities when signs of danger appear will become more frequent. More frequent in national bank closures. And more frequent in assuring that bankers recognize their problems and that they follow up to correct them. At the same time, we're taking steps to make sure we're balanced, reasonable, and consistent in the way we supervise banks.

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For the last three years, all of us — bankers and bank regulators — have had the writing on the wall read to us. By now, everyone knows what it says — and what it means for the future.

Statement of Cantwell F. Muckenfuss III, Senior Deputy Comptroller for Policy, before the House Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the Committee on Banking, Finance and Urban Affairs, on adjustable rate mortgages, Washington, D.C., September 22, 1981

Mr. Chairman and members of the subcommittee, we appreciate this opportunity to present the views of OCC on adjustable rate mortgages (ARMs).

These hearings are timely in light of the Federal Home Loan Bank Board and OCC actions on ARMs, the plight of housing and the housing finance system and, most importantly, the distress of thrift institutions. The hearings provide an opportunity to report why we determined it was imperative to go forward with ARMs and to explain the rationale for the specific actions we took.

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Historically, depository institutions have been tightly regulated. A framework of law and regulation has controlled entry, restricted the ability to expand geographically, regulated prices, and defined permissible products and areas of activity. Areas of specialization in the provision of financial services, such as a focus on housing finance, are codified; products are defined by law and not by the demands of the marketplace. Similarly, profitability and competitiveness have often turned on governmental pricing decisions rather than the exercise of private discretion. Although our financial system has served us well, it is evident that major aspects of this framework are incompatible with the realities of the marketplace and are creating serious dislocations for financial institutions and their customers.

The plight of mortgage lenders provides a case in point. Inflation and high and volatile interest rates have had devastating effects on those financial institutions, predominantly thrift institutions, whose asset portfolios are composed primarily of long-term, fixed-rate mortgages. During much of the post-World War II period, the mismatched asset-liability maturity structure of thrifts worked relatively well. However, the current volatile interest rate environment, in which short-term rates frequently have exceeded long-term rates, and the dramatic upward shift in the cost of funds, caused by inflation and the increased interest sensitivity of depositors, have seriously impaired the profitability of such an asset-liability maturity structure. Indeed, many thrifts are locked into low, fixed-rate, 30-year mortgages that do not provide enough revenue to pay interest on deposits let alone cover operating expenses.

The effects of inflation and interest rate volatility have been amplified by deposit rate deregulation, which began with the money market certificate in mid-1978 and which, under the provisions of the Depository Institutions Deregulation and Monetary Control Act, will result in total elimination of controls no later than March 31, 1986. Rate deregulation, or course, became imperative when inflation-induced high interest rates led to outflows of deposits into unregulated market-rate instruments and created concerns about providing small savers with the opportunity to realize market rates.

In light of those conditions, we became convinced that the flexibility to offer adjustable rate mortgages is essential for depository institution participation in home mortgage finance. Indeed, it is clear that past reluctance to provide thrift institutions with asset flexibility has contributed to their current plight and to the dearth of mortgage credit flowing from them. Accordingly, we determined that we should act affirmatively to facilitate the offering of ARMs by national banks. Although enhanced flexibility will do nothing to ameliorate the consequences of a portfolio composed of long-term, low-interest loans, we believe that it will increase the flow of funds to housing and have a moderating impact on the cost of mortgage credit.

The problems of the thrift industry illustrate most graphically what can happen when there is lack of flexibility to adjust to changing circumstances. The larger lesson should not be lost.

Fundamental forces are reshaping the financial services industry—both in our country and abroad: inflation and economic uncertainty, erosion of geographic barriers to competition, erosion of product market barriers, deregulation of the liability side of the balance sheet, demographic shifts, and the revolution in telecommunications and data processing technology.

Because of the pervasive impact of law, regulation, and public policy, the health and vitality of the financial system in the coming decades will reflect not only the

**Portions of this testimony have been deleted due to space limitations. The unabridged version is in volume 1, number 1, pages 42-50 of the Quarterly Journal.*

forces of the marketplace but of equal importance, decisions made in the public sector—by Congress and the regulatory authorities—in light of those forces. The actions of the agencies with respect to adjustable rate mortgages reflect such decisions. However, they constitute but a part of a much larger agenda of financial reform that is essential if regulated deposit-taking institutions are to have the flexibility to adjust and compete effectively. The urgency of that undertaking has been recognized by Congress and the Administration. The committee's proposed "discussion draft," the Federal Home Loan Bank Board's proposed legislation, and other bills and materials will provide a solid foundation for moving ahead seriously and expeditiously with financial reform.

In the discussion that follows, we describe and explain our actions with respect to ARMs and then turn to the larger agenda that is before us.

Comptroller's Adjustable Rate Mortgage Regulation

Two judgements led principally to the office's commitment to consider adoption of a regulation that would explicitly authorize national banks to make or purchase ARMs. First, it was our judgment that fixed rate lending in the face of high and volatile rates has been very difficult, if not imprudent, and that mortgage lending would prove substantially more attractive for national banks if granted a flexible framework. That judgment reflected two considerations. Pre-emption of state laws which significantly inhibit or forbid ARM lending enhances the attractiveness of mortgage lending in those states. Moreover, we believe that the provision of a uniform and flexible federal framework which provides a known legal environment and acceptable standards for disclosure will encourage national banks to participate in mortgage lending.

Second, the decision to consider adoption of an ARM regulation reflected concern that a proliferation of new instruments, combined with the relative novelty and potential complexity of the instruments, would create substantial borrower confusion. In addition, the lack of a national set of disclosure standards for national banks would make it more difficult for the office to supervise.

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Four fundamental decisions were made in formulating the ARM regulation. First, we rejected the option of specifying a single adjustable-rate mortgage instrument for national banks. Economic conditions in the country's local markets and the needs of borrowers and lenders were simply too varied to be satisfied by a single mortgage instrument. We concluded that the better course lay in establishing a flexible legal framework within which borrower and lender can arrive at a contract satisfying the needs of both.

Second, we concluded that we should pre-empt state law in that area, including both permissive and restrictive regulatory regimes, with a comprehensive federal approach. The framework that was developed will enhance mortgage availability in those states which were unduly restrictive and yet, due to its built-in flexibility, will not stifle innovation in states which are more permissive. Moreover, as we have indicated, we believed that a significant need existed for a uniform set of disclosure standards to facilitate borrower comprehension of the options made available through those new instruments.

Third, we determined that the regulation should be somewhat more flexible than originally proposed. For example, the regulation as adopted provides for a 2 percentage point annual cap on interest rate movement rather than the 1 percentage point cap which was proposed. That reflected the view that the risks to borrowers posed by significant variations in rates were outweighed by the benefits to be derived from the increased availability of funds provided by lenders attracted by the more flexible instruments and the downward pull on price resulting from increased competition. Moreover, borrowers should also benefit because lenders need not set the interest rate as high on ARMs as on fixed rate mortgages in light of reduced interest rate risk. We also believe that in a competitive lending environment many institutions will choose to compete with instruments that do not use the full latitude provided by the regulation.

Fourth, we decided that alternative mortgage instruments that limited monthly payment changes but did not limit periodic interest rate changes should be permitted to develop outside the limitations on the ARM regulation. That action was taken with the intent of encouraging marketplace experimentation and not foreclosing the potential development of better mortgage instruments. However, because of our concern for insuring appropriate consumer safeguards, we required national banks wishing to offer such instruments to submit their plans for review at least 60 days prior to their intended introduction date. Those banks with programs in place were permitted to continue but were required to submit details to the office for review.

Events during the past year reinforced our judgment that an adjustable rate mortgage regulation is necessary. Interest rate ceilings on the popular 6-month money market certificate of deposit ranged from 7.75 percent in June of 1980 to 15.92 percent in May of 1981. At the end of July, 48 percent of commercial bank deposits were in rate-sensitive liabilities, including

large negotiable certificates of deposit, money market certificates of deposit and two and one-half year small-saver certificates. The market values of fixed rate, long-term mortgages made a year ago have suffered a decline of more than 20 percent due to higher interest rates. As a consequence of that decline and those stemming from low rate mortgages made in previous years, it is becoming increasingly difficult for borrowers to obtain fixed rate mortgage loans except from lenders with access to federally sponsored agencies or private investors willing to purchase those loans.

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Monitoring ARM Lending by National Banks

We intend to monitor systematically the effects of our ARM regulation on the supply of mortgage credit, both generally and to specific groups likely to experience difficulty in affording housing. We are considering a program to monitor national bank residential mortgage activity similar to the ongoing analysis of savings and loan associations' activities by the Federal Home Loan Bank Board. Some of that can be done through modifications to our data-collection forms currently in use in our fair housing home loan data system. If we are correct in our belief that the introduction of ARMs will significantly increase the role of national banks in the real estate market, it will be desirable to collect and analyze more detailed information on commercial bank mortgage commitments, mortgage originations and sales, terms, and conditions on mortgages closed and portfolio holdings. Such information will provide a basis for future rulemaking and for recommending changes to existing statutes.

We also intend to monitor the impact of ARMs on low- and moderate-income areas and on women and minorities. Concern has been expressed that individual banks offering ARMs might fail to satisfy their obligations, as expressed in the Community Reinvestment Act, to help meet the credit needs of their entire communities, based on unsubstantiated perceptions that property prices or incomes of residents in low- and moderate-income areas will not increase in line with the general inflation rate. Similarly, it is possible that lenders might use loan evaluation criteria, including unsubstantiated projections of future income growth, that could have the effect of illegally discriminating against minorities, women, or other groups protected by the Equal Credit Opportunity Act and the Fair Housing Act. If the results of our evaluation indicate an adverse impact on the objectives of those laws, the office will consider amendments to the regulation and other actions to address the problem. If results of the evaluation suggest no adverse impact or a positive impact, the office will consider eliminating the monitoring program and may also permit additional flexibility in the ARMs that national banks may offer.

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Secondary Market Developments

The secondary market plays an important role in our housing finance system by channeling funds to primary market lenders. The Federal National Mortgage Association's recently announced plan to launch a mortgage-backed securities program has the potential to expand greatly the importance of the secondary market by attracting billions of investors' dollars into the conventional mortgage market, just as the Government National Mortgage Association's mortgage-backed securities have channeled funds into the government-insured mortgage market. Plans call for some of those securities to be backed by adjustable rate mortgages.

In response to the office's and the Federal Home Loan Bank Board's regulations dealing with ARMs, the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association have developed ARM purchase plans. Most of the plans announced by the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association have no limitations on periodic interest rate adjustments. Those plans without rate caps protect borrowers against extreme payment volatility through explicit limitations on changes in monthly payments, through relatively infrequent payment adjustments, or through use of a relatively slow-moving interest rate index. To protect secondary market investors against the risks that negative amortization may present, the plans that permit negative amortization limit it to 25 percent of the original loan balance.

The office will monitor carefully the secondary market's demand for the various types of ARMs. It is possible that rate-capped ARMs will be less attractive than nonrate-capped ARM's because some of the interest rate risk may be borne by the ultimate holder of the mortgage. Early indications are that secondary market investors have required that rate-capped ARMs yield approximately 20 to 30 basis points more than ARMs without caps.

However, we should emphasize that the market for ARMs is in an early stage of its development. The secondary market acceptance of various ARMs will provide valuable guidance to the office regarding the need to modify or increase the flexibility of the ARM regulation.

In your September 16 letter, you asked that we comment on your draft bill that would grant the Federal

Home Loan Mortgage Corporation and the Federal National Mortgage Association increased flexibility in purchasing mortgages originated more than one year prior to the purchase date. That would, of course, serve to increase the liquidity of mortgage portfolios. We are in agreement with that proposal and support its enactment.

Future Office Initiatives

The office is considering further initiatives in the residential mortgage lending area which might moderate the affordability problem and encourage bank residential real estate lending activity. Future actions under consideration include reviewing other types of mortgage instruments, pre-empting state restrictions which have the effect of discouraging fixed rate lending, and proposing revisions to the statute controlling national bank real estate lending.

First, the office intends to review the merits of other types of mortgage instruments designed to respond to the affordability problem. For instance, in a period of prolonged inflation accompanied by high and volatile interest rates, the standard fixed rate mortgage requires a monthly payment that is high, in real terms, in the early years of the loan. The nominal value of the monthly payment remains constant but, taking into account the effect of inflation on the purchasing power of the dollar, the real value of the monthly payment shrinks over time. Thus, many families who are good credit risks in terms of future income growth may have difficulty qualifying for a mortgage loan because of the high initial monthly payments. We intend to review carefully a wide variety of proposals designed to meet that problem, including the graduated-payment mortgage loan, the graduated-payment adjustable-rate mortgage loan and the price-level adjusted mortgage now offered in several countries.

Second, the office has sent to the *Federal Register* for publication a proposed regulation which would remove or reduce a restriction that has the effect of discouraging long-term, fixed rate lending. Specifically, most conventionally financed mortgages have due-on-sale clauses requiring that the loan be repaid at the lender's option if the property securing the loan is sold. With the rise in mortgage rates, mortgage loans made several years ago with lower interest rates have become valuable "assets" for borrowers and costly "liabilities" for lenders. Various state courts have ruled in the last few years that due-on-sale clauses may be enforced only when lenders can demonstrate that their security is impaired by the transfer of the property. In addition, a number of state legislatures have passed laws prohibiting, in whole or in part, the enforcement of due-on-sale clauses. Those laws and rulings have provided a windfall benefit to current holders of mortgages in those states because they can sell their mortgage obligations as a valuable asset apart from the value of the encumbered property. As a consequence of those rulings, long-term fixed rate mortgage lending in those states has been discouraged. To address that issue, the office has proposed a regulation which will, if it becomes a final rule, authorize national banks to enforce due-on-sale clauses according to their terms. That rule will apply to new loans and also to most loans made at a time when, under state law, it would have been reasonable to conclude that the clauses were enforceable.

The Federal National Mortgage Association, the single largest investor in residential mortgages, recently announced a policy of requiring lenders subject to state prohibitions of due-on-sale clauses to include a provision in their loans permitting the Federal National Mortgage Association to call the loans at the end of seven years. Similarly, the Federal Home Loan Bank Board and the National Credit Union Administration have determined that their rules permitting enforcement of due-on-sales clauses pre-empt state law and that therefore federally chartered savings and loan associations and federal credit unions are not subject to such restrictions. The federal banking agencies are satisfied that Congress has granted them the authority to promulgate pre-emptive regulations in that area.

Third, the office has been considering the effects of the restrictions imposed on a national bank real estate lending by the provisions of 12 U.S.C. 371. Those restrictions are intended to put such real estate lending on a safe and sound basis, but we believe that they might unduly inhibit national bank participation in the evolving residential real estate finance market. In particular, the rigid loan-to-value ratios, the amortization requirements, and the aggregate limitations on total real estate lending, construction lending, and second-lien real estate lending often deter national banks from engaging in transactions that could at once be prudent and profitable and also satisfy the needs of their customers. We believe that, while those subjects are relevant to the sound management of real estate lending, rigid predetermined limitations are often at variance with evolving market realities. We intend, in the near future, to propose legislation to amend 12 U.S.C. 317 to authorize national banks to make real estate loans subject only to any limitations that the Comptroller might impose. That legislation, we believe, would allow national banks greater flexibility and encourage innovation, while at the same time ensuring that mortgage lending is being done prudently and with appropriate safeguards for consumer interests.

... ...

Statement of C. T. Conover, Comptroller of the Currency, before the Senate Committee on Banking, Housing, and Urban Affairs, on Penn Square Bank of Oklahoma City, Washington, D.C., December 10, 1982

I welcome this opportunity to discuss the actions of the Office of the Comptroller of the Currency (OCC) concerning the Penn Square Bank of Oklahoma City, which was declared insolvent on July 5, 1982.

While the failure of the Penn Square Bank raises many questions, two are particularly pertinent to the agency:

- Why did the bank fail despite our supervisory efforts?

- Should our bank supervisory procedures and regulations be changed in light of the failure and, if so, how?

I will deal principally with these questions. To aid the committee in its review of the Penn Square Bank failure, I have also provided, as an appendix to my statement, a summary of OCC policies and procedures affecting problem banks and a more detailed history of OCC's supervision of Penn Square Bank.*

Overview of the Failure

To understand why the Penn Square Bank failed despite our regulatory actions, the direct cause of the failure must be considered: poorly conceived and poorly documented loans that violated prudent banking policies and procedures. The bank had concentrated its loans in the Oklahoma oil and gas production industry. In late 1981 and early 1982, that industry suffered a severe and unexpected decline. Many of Penn Square's major customers began to experience financial difficulties. Rather than reducing its exposure to these firms, Penn Square extended more credit in an effort to "bail out" its customers. In late 1981 and early 1982, the bank originated an extraordinary volume—over $800 million—in new loans. The vast majority of those new loans were to energy-related borrowers.

When the decline in the oil and gas industry continued to deepen, many of the new loans became non-performing. Loan losses greatly exceeded the bank's capital, thus resulting in a book insolvency. Simultaneously, a severe decline in market confidence in the bank led to a run-off of deposits and other funding sources, thus causing a liquidity insolvency. Accordingly, the combination of a large volume of poor quality credits and a severe downturn in economic conditions directly resulted in the failure of the bank. A primary cause of the insolvency was that the Penn Square management heedlessly disregarded the principles of safe and sound banking and failed to comply with OCC directives.

OCC Supervisory Actions

A Chronology of Events

In 1980 Penn Square Bank was assigned a "3" rating under the Uniform Financial Institutions Rating System despite the absence of many of the usual quantitative indicators for a bank requiring special supervision. OCC was concerned about the bank because of its poor liquidity and funds management, deficient capitalization, and lack of staff expertise. Essentially, we thought the bank's resources were stretched very thin by its extremely rapid growth. In light of the bank's strengths, however, a more severe "4" or "5" rating was not warranted. At that time, the overall quality of the loan portfolio was acceptable and its earnings exceeded those of its peers.

Because of its weaknesses, the bank was placed in OCC's Special Projects Program to receive additional supervision. As part of that program, we required, and the bank consented to implement, remedial measures for the identified problems. Through a formal agreement signed by each director under 12 U.S.C. 1818(b), OCC required the bank, its board, and management to: increase capital; formulate and implement a more stringent loan policy, and establish improved internal review procedures to enforce that policy; develop and implement acceptable policies on liquidity, asset, and liability management; and evaluate and strengthen its staff and management.

The formal agreement, signed in September 1980, was consistent with our guidelines relating to problem banks. The office thereafter undertook to monitor implementation and compliance by the bank with that agreement. The bank was examined with the same scope and frequency accorded other "3" rated banks.

We expressed concern over the concentration of credits to oil and gas interests and questioned whether such a concentration was consistent with prudent risk

The appendix to this testimony has been omitted. It may be found in volume 2, number 1, pages 62-63, of the Quarterly Journal.

diversification. Nevertheless, we felt that the decision of whether the bank should continue to make loans in the oil and gas industry, provided such loans were of good quality, was within the discretion of management and the board. The bank's strong prior earnings record and the then favorable prospects in 1980 for the energy industry mitigated our concerns regarding those loan concentrations. We did not feel that restrictions on the growth of the bank were necessary or appropriate if such growth conformed to the terms of the agreement, particularly the requirement that capital be maintained at 7.5 percent of assets.

After initial resistance, the bank's management agreed to implement OCC's proposed remedial measures. By September 1981, the bank appeared to have substantially complied with most of the OCC directives. More particularly, the bank had adopted an adequate capital plan, had increased its capital to an acceptable level; had hired experienced management and lending officers; had adopted an adequate loan policy that required approval by a committee, the chairman, or the president of all loans over $50,000; had created an internal loan review procedure to ensure compliance with the policy; had adopted acceptable policies on liquidity, asset and liability management; and had hired a new chief financial officer to oversee that area. Most significantly, the bank had brought on a new management team which appeared to be competent, in control, and fully committed to improve the bank's condition in a manner consistent with OCC directives.

In normal circumstances, such measures could be expected to improve the bank's condition. Thus, the "3" rating was continued through the September 1981 examination. However, following the September 1981 examination, largely in response to difficulties in the energy industry, the bank engaged in various transactions which were wholly inconsistent with prudent banking practices and in wholesale disregard of agreed upon lending policies and procedures. These actions made the failure of Penn Square Bank inevitable.

As previously noted, between the September 1981 examination and the commencement of our examination in April 1982, the bank originated approximately $800 million in new loans largely to its oil and gas customers who were beginning to experience financial difficulties due to a severe decline in their industry. Domestic drilling activity (as represented by the number of active drilling rigs) was substantial and growing until late 1981, at which time the industry faltered. Penn Square's lending continued to increase beyond that time [illegible] of the industry's decline.

Many of these loans were of poor quality and violated [illegible] policies and review procedures mandated by OCC. The extraordinary volume of loans generated was almost twice the size of the bank. It is virtually impossible to prudently manage such explosive growth. By the bank's own count, there were over 3,000 documentation exceptions in the loan portfolio. Many liens were not filed, some had not been taken, and some notes were even unsigned. A large percentage of those loans eventually resulted in loss which caused the bank's failure. Of the $49.1 million in assets eventually classified as loss, approximately $28.5 million (or 58 percent of losses) had been booked after the September 1981 examination. Had the examination initiated in April 1982 been completed, the bank's rating, would certainly have been increased from a composite "3" to a composite "5." The declaration of insolvency, however, overtook such a redesignation.

Reason for Failure Despite OCC Supervision

The bank failed despite OCC's supervision, in significant part, because bank management acted imprudently and abandoned their compliance with our remedial directives. If the bank had fully implemented the terms of the agreement, its condition would not have deteriorated so rapidly and, very probably, would have improved. Indeed, OCC supervisory procedures and directives, as we followed with respect to Penn Square Bank, have proven to be overwhelmingly effective with "3" rated banks.

The management of Penn Square failed or refused to adhere fully to the agreement which likely would have prevented the failure. We received repeated assurances from management and the board of directors that the bank would fully comply with the agreement. If Penn Square had ever openly refused to cooperate with our supervisory efforts, OCC would have taken stronger action.

By the time OCC returned to the bank in April 1982, the bank had, during the few months between examinations, radically altered its course and thereby assured its own failure. The bank's extraordinary imprudence resulted in:

- classified assets which were 352 percent of gross capital funds;
- delinquency in almost 13 percent of the loan portfolio; and
- more than 3,000 credit and collateral documentation exceptions.

The conduct of some bank officials was so egregious as to warrant our referral of particular matters to the

United States Attorney for possible criminal prosecution.

We followed established and generally successful examination and supervisory procedures in addressing the problems of the bank based upon the facts known to us at the time. However, our experience with Penn Square demonstrates that the agency's supervisory effectiveness is to some extent limited by the responsiveness (or unresponsiveness) of a bank's management and board to our efforts. Over the long-term, OCC will usually detect and overcome management resistance. However, in the short-term, our supervisory efforts can be defeated by a bank management that promises one thing and does another. Such actions are irresponsible in the best of times. They are disastrous in an economic environment that changes very quickly, as did the oil and gas industry. Essentially, this is what occurred at Penn Square.

Limits of Federal Bank Supervision

The extent to which OCC can or should direct the affairs of national banks is practically limited. Our banking system is a private enterprise system. Consistent with our nation's fundamental economic philosophy, the basic strategy of the federal bank supervisory agencies is to work with bank management to detect and control the risk exposure of their institutions, and to assure a high level of bank compliance with applicable laws and regulations. The role of OCC may be defined as supervisory. We do not take over and manage institutions; we do not substitute for private management. However, if a bank refuses to cooperate, OCC vigorously enforces laws and prudent banking standards within the limits of due process.

In extreme cases, OCC can, consistent with statutory requirements, remove or suspend an officer, or order that bank management carry out or refrain from particular acts.

Generally, however, when a bank is experiencing problems and requires special supervision, OCC will direct the bank management to implement remedial measures and, when appropriate, we will order such changes through formal and informal administrative actions.

In the final analysis, the agency's ability to affect the condition of a bank depends upon the execution of our directives by the officers and directors of the bank. It is not desirable for the regulator to substitute for bank management. A necessary consequence of this properly limited role of bank supervisors is that some banks can and will fail despite our best efforts. In the short-term, unless we permanently assign a team of national bank examiners to review all decisions made by a bank, management can deceive us as to whether it is complying with our directives. Despite this risk, the agency must presume the honesty and good faith of management. The bank supervisory system could not operate under a presumption of management dishonesty.

Penn Square's disregard of the agreement was not detectable by OCC's remote monitors because the violations were basically qualitative rather than quantitative in nature. The data in current call reports does not readily reflect changes in the quality of a loan portfolio between examinations. The recently announced changes in call report data should help to alleviate this problem.

More Stringent Action Was Not Warranted

Would the failure have been prevented if OCC had made more extensive use of its formal administrative powers? In my opinion, no.

OCC had considered issuing, and indeed had threatened to issue, a cease and desist order against the bank. However, in practical terms, such an order would have contained essentially the same requirements as the agreement. Moreover, OCC monitors day-to-day compliance with orders and agreements in essentially the same way. Finally, in light of the apparent cooperation of the bank's management and directors, such an order did not seem warranted.

Neither removal of officers nor civil money penalties were justified in light of the information known to us before the April 1982 examination. While OCC was concerned with the lending activities of Mr. Patterson, senior executive vice president in charge of the energy department, prior to the spring of 1982, we did not believe that his activities or those of anyone else were sufficiently egregious to satisfy the requirements for removal under 12 U.S.C. 1818(e)(1). By the time we became aware of information that would have justified the removal of any officer or director, the damage to the bank had been incurred and its failure was all but inevitable.

The Lessons of Penn Square

Finally, we come to the other question: Should bank supervision and regulation be changed in light of the failure? As noted before, the primary reason for the bank's failure despite OCC supervisory efforts was that imprudent banking practices resulted in so rapid a deterioration that OCC had insufficient time to implement effective remedial measures. During the period between our examinations, and contrary to its assur

ances, the bank went on a binge of imprudent lending. Pushed on by unrealistic optimism for a recovery of the energy industry or in an effort to hang on and minimize losses, the bank went too far in extending new credit.

Our experience with Penn Square has confirmed certain conclusions OCC had already reached. Under our recently implemented policies, OCC will examine all "4" and "5" rated banks and "3" rated banks with assets of more than $100 million more frequently. OCC also will assign more of its examining resources to such banks. The rapid deterioration of Penn Square Bank between exams underscores the need to increase the frequency of examination of banks with composite ratings of "3" or higher.

Among the other specific issues that the OCC is further reviewing in light of the Penn Square Bank experience are:

- Whether OCC should provide more frequent examinations for banks engaged in large sales of loans and participations;

- Whether OCC can make additional improvements in its remote monitoring system to increase our ability to detect rapid changes in a bank's loan portfolio;

- How OCC might better use information obtained while examining one bank in examining other banks; and,

- What additional information about banks should be publicly disclosed.

These are not easy questions, but they must be answered. Some preliminary conclusions can be drawn from the Penn Square Bank failure.

The adverse effects of the failure could have been reduced if the public and the bank regulators had been provided with better and more timely information on the condition of the bank. This suggests several remedial measures to increase the quality of market discipline and supervisory oversight by improving the amount and quality of information available, particularly from non-registered banks (like Penn Square Bank) that are exempt from many disclosure requirements.

First, the federal bank regulators are changing the Report of Condition and Income, commonly known as the "call report." To provide the regulators with more information about banks, to permit assessment of the quality of loans and leases, banks will be required to report loans past due, nonaccrual and renegotiated loans and leases, and the amount of charge-offs and recoveries during the reporting period. Other revisions will require banks to report maturities of assets and liabilities and interest rate repricing opportunities to aid in the analysis of rate sensitivity and rate risk. Finally, to provide improved reporting of income and expenses, all banks will eventually be required to report on a full accrual basis of accounting.

Second, we intend to publicly disclose more information about the condition of banks. Deregulation should result in shifting some of the responsibilities for the discipline of banks from the regulators to the marketplace. If the marketplace is to function efficiently and provide adequate safeguards against excessive risk, market participants must have adequate information. For that reason, information on loans past due for 90 days will be made public beginning with the June 30, 1983 call report. The office is also considering other disclosures, such as publication of income statements and making certain types of enforcement actions public.

New Legislation Is Not Needed

There is, however, no need for enactment of legislation at this time to address the specific practices that led to the Penn Square Bank failure. That failure was, in large part, an aberration arising from unique circumstances. Penn Square Bank justifies neither increased regulation nor reduction in the pace of deregulation of banking.

The bank's failure raises in stark terms a fundamental regulatory question: Do we want and can we afford a failsafe banking system? The answer must be no.

The possibility of a business failure plays an important role in the free enterprise system. Failures remove inefficient firms so that the resources they consume may be allocated to their more efficient competitors. Most importantly, the threat of failure is essential if the discipline of the marketplace is to function.

The lack of a credible threat of failure can have two adverse effects upon businesses. First, any company may not operate as efficiently if not faced with a risk of collapse. The threat of failure motivates banks to be vibrant and responsive to changing needs for financial services. Second, a business that cannot fail may be inclined to imprudently engage in high risk activities that offer potentially large profits. This second effect has profound implications for banking. Indeed, such thinking may have influenced some of the banks that purchased large quantities of loans and participations from Penn Square Bank. They, and we, have undoubtedly learned a valuable lesson from the failure.

The risk of a failure motivates investors and depositors, not directly involved in managing the bank but who still

have a stake in its soundness, to monitor carefully the performance of the bank's management with regard to risk exposure.

A failsafe banking system would forfeit these important benefits. It would also incur unacceptably high social and financial costs. In order to eliminate the risk of serious errors or transgressions that could result in a bank's failure, the freedom of bank management to make business decisions would be curtailed and supplanted by regulatory supervision. The social costs from the resulting loss of individual liberty, entrepreneurial initiative, and industry efficiencies obviously would be unacceptable. Our banking system would become stagnant and unresponsive. Further, such a system would require almost constant examination of banks because, as we have seen in Penn Square, a bank can change radically in a very short time. The maintenance of such a system would be extremely expensive.

The public interest warrants reasonable supervisory safeguards to assure a safe, sound, and efficient banking system. This requires a high degree of bank monitoring, supervision and, in some cases, even coercion to prevent excessive bank failures. However, the public interest would not be well served by a regulatory system that is so restrictive or so protective as to eliminate the risk of failure altogether.

The failure of the Penn Square Bank, if understood in light of its peculiar circumstances and the conduct of its management and directors, does not demonstrate a need for more federal regulation of banks.

Statement of C. T. Conover, Comptroller of the Currency, before the House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, Committee on Banking, Finance and Urban Affairs, on the LDC debt crisis, Washington, D.C., April 21, 1983

Mr. Chairman and members of the subcommittee, I am pleased to offer my views on the international financial situation and, in particular, the supervision of international banking. My statement is divided into two parts. The first part describes commercial bank lending to the developing countries. The second part discusses current and proposed financial, supervisory, and banking responses to the developing countries' debt problems.*

Bank Lending to Developing Countries

U.S. commercial banks have been active in international finance since the early 1960s. Today, they are both major lenders and deposit-takers in overseas markets. As of June 1982, U.S. bank loans, interbank deposits, and acceptances to both foreign and domestic borrowers totaled $1.3 trillion. Roughly one-quarter of that amount, $344 billion, consisted of credit to foreign borrowers denominated in non-local currencies.

U.S. banks are active lenders in both the industrialized and developing countries. Fifty-seven percent of U.S. banks' loans overseas are to the industrialized countries. Loans to the non-oil producing less developed countries (NLDCs) account for 30 percent; 7 percent are to oil producing LDCs that generally have low financing needs. Most of the remainder are credits to offshore banking centers (4 percent) and Eastern Europe (2 percent); Yugoslavia accounts for a major portion of loans to East European countries.

Overall U.S. bank international exposure is diversified. U.S. bank exposures exceed $5 billion in each of 18 countries, all of which are important trading partners of the U.S. The relative loan exposure to most of these countries roughly parallels their relative importance as U.S. trading partners.

Significant commercial bank lending to the NLDCs began with the first OPEC price increase in 1973 and grew rapidly thereafter. As of June 30, 1982, the NLDCs had external debt of about $580 billion. Approximately one-half of this amount was owed to foreign commercial banks, of which $100 billion was owed to U.S. banks.

Six NLDCs—Mexico, Brazil, South Korea, Argentina, Chile, and the Philippines—have experienced rapid growth and have represented growing markets for U.S. exports. Exposure to the six NLDCs as of June of 1982 amounted to $75 billion—only 20 percent of U.S. bank international loans, or about 6 percent of total loans.

In each of these countries, U.S. bank loans account for no more than one-third of total external debt. Even in the case of Mexico, our close neighbor and third largest trading partner, non-U.S. commercial banks have loans one and one-half times the amount loaned by U.S. banks. Moreover, the U.S. share of lending in Mexico and other Latin American countries has generally declined through the 1970s as non-U.S. banks have moved into this growing market.

To understand the various reasons for the rapid increase in bank lending to the NLDCs, it is helpful to divide the last decade into two periods. The first period extends from the 1973-1974 OPEC price increase up to the second OPEC price increase in 1979-1980. The second period begins with the 1979-1980 OPEC price increase and continues through today.

Reasons for Increased Bank Lending to NLDCs (1973-1978)

Lending to the NLDCs by commercial banks in the industrialized countries grew rapidly for four reasons. First, the external financing needs of the non-oil producing countries increased significantly during this period. Three factors contributed to these increased needs:

- Rapid economic growth: The economies of the NLDCs were growing rapidly, and domestic savings, while high as a percentage of GNP, were insufficient to finance the capital investment required by their development plans.

- Rapid increase in the price of oil: The fourfold OPEC oil price rise of 1973-1974, which increased the OPEC current account surplus from $7 billion in 1973 to $68 billion in 1974 resulted in a corresponding deterioration in the current account positions of all oil importing nations. Higher oil prices, in combination with the worldwide recession they fostered

*Charts relating to U.S. bank exposure to LDCs have been omitted as well as material relating to nonregulatory responses to the LDC debt crisis. The unabridged version is in volume 2, number 3, pages 17-25 of the Quarterly Journal

combined to quadruple the NLDC current account deficit over two years, from $11 billion in 1973 to $46 billion in 1975.

- Policy decisions to finance both economic growth and oil price increase: To avoid the economic dislocations that could result from a rapid adjustment to the oil shock, many oil importing countries, both industrialized and developing, decided to stretch out the adjustment process by financing the higher cost of oil. Low or negative real interest rates made this option particularly attractive. In the NLDCs, the need to finance the oil price increases was superimposed on an ongoing need to finance economic development. Much of this additional financing came from foreign sources, including banks.

The second reason for increased commercial bank lending was that the growth rate of financing needs in the more advanced NLDCs outpaced the growth of bilateral and multilateral assistance. Official lending agencies also shifted their concessionary financing toward the poorer LDCs. The larger and more creditworthy NLDCs thus relied more on private sources for their external financing. As a result, the share of these NLDCs' debt held by private lenders has increased over the last decade.

Third, Western governments had economic reasons to encourage commercial bank lending to the developing world. The heaviest borrowers generally represented large and growing markets for OECD exports. The real rate of economic growth of the NLDCs since 1973 has consistently exceeded that of the United States and the OECD as a whole. Increasing the level of external financing enabled NLDCs to continue to pursue economic development while, at the same time, providing growing export markets and jobs for industrialized countries. U.S. exports to the six major NLDCs rose from $7 billion in 1973 to almost $22 billion in 1979.

Fourth, NLDCs represented new, growing, and profitable markets for commercial banks. Moreover, the need to recycle OPEC surpluses required the banks to provide an essential intermediation service between the OPEC countries with large volumes of funds to invest and the NLDCs with current account deficits. Bank lending was concentrated in those NLDCs believed to have high potential as markets for banking services and exports from industrialized countries.

Lending to these nations appeared profitable. Fees exceeded 1 percentage point, and many loans were priced at up to 200 basis points above the London interbank offered rate (LIBOR). These fees, and spreads seemed especially attractive since postwar international lending had led to few repayment problems.

The initial profitability of the NLDC markets attracted new lenders and resulted in two gradual changes. First, many smaller banks that were less experienced in international lending became participants, and second, competition contributed to a reduction in fees and spreads. By the end of the 1970s, many loans were being made at 75 basis points or less above LIBOR.

By 1978, it appeared that the challenge of the first oil shock had been met. Oil prices had stabilized, and the OPEC current account surplus was approaching zero. Economic growth in the West was entering its third year. With the help of international borrowing, many parts of the developing world were experiencing economic growth above the levels of a decade earlier.

Nonetheless, the NLDCs were particularly vulnerable to future economic shocks. Their capacity for taking on additional debt was limited by previous heavy borrowings that would begin to mature in 1980-1982 and would have to be rolled over. In addition, real interest rates had remained historically low throughout the mid-1970s; any increase would raise the cost of servicing existing and future debt.

Lending to NLDCs After 1979-1980 Oil Price Increase

In 1979, oil prices again began to increase sharply. By the end of 1980, OPEC oil prices exceeded $34 per barrel, a 160 percent increase over 1978 prices. Once again the world faced a fundamental decision—whether to inflate or to adjust. This time most industrial countries decided to make major adjustments in their monetary and fiscal policies.

As a result, the NLDCs faced a less favorable economic environment after the second oil price increase than after the first oil shock, and some did not begin their adjustment soon enough. Economic growth slowed in the industrial countries, thereby reducing demand and lowering prices for NLDC exports. The NLDC trade deficit, already hurt by higher oil prices, therefore began to increase. The need to finance this widening trade deficit contributed to an increasingly rapid growth in NLDC debt; by the end of 1980, NLDC debt had reached $465 billion, nearly four times the amount outstanding at the end of 1974.

A large proportion of this debt had been made on nonconcessionary, floating rate terms. As both nominal and real interest rates rose sharply and medium-term debt from 1973-1974 began to mature, debt service payments rose rapidly. Principal and interest payments increased from $77 billion in 1980 to $108 billion in 1982.

The result was a rapid increase in the NLDCs' average debt service ratio during 1981. Debt service ratios for four of the six NLDCs that were major borrowers from U.S. banks increased even more rapidly than the average. Moreover, in addition to these rapidly increased debt service costs, NLDCs also had to finance current needs, at a time when export earnings were stagnating.

Despite the deterioration in the financial condition of the NLDCs, commercial banks continued to increase their exposure to these countries in the expectation that the worldwide economic slump would be short-lived. Lending to the six major NLDCs increased almost 30 percent per year in 1980 and 1981 and rose an additional 10 percent during the first six months of 1982.

Conditions in each of the three largest borrowing NLDCs seemed to indicate that additional loans could be safely extended. In 1980, Brazil began to undertake its own severe monetary and fiscal adjustment program and sharply reduced its trade deficit. Argentina was able to maintain a strong balance of trade surplus until the Falkland Islands War. Mexico's debt service capacity seemed to be rapidly growing as its proven oil reserves swelled at the very time that real oil prices were rapidly increasing.

Nonetheless, bankers exhibited more caution during this period. Loan pricing became more cautious as spreads once again increased. Banks also began to sharply reduce the maturity of new loans—in many cases to only one or two years. What appeared to be a cautious move by each bank, however, actually increased the instability of international markets in 1982 as many of these loans came due.

In 1982, a number of events combined to cause a major shift in market expectations about the creditworthiness of NLDCs. The general forecast of a relatively short recession in the West gave way to uncertainty about when recovery would occur. Expectations of rising oil prices gave way to growing perceptions of an oil glut. Deflation seemed suddenly more likely than continued inflation. Confidence in international lending was shaken by a number of shocks to the international credit and interbank markets, such as Poland, Penn Square, Drysdale, Banco Ambrosiano, and the Falklands War.

In the midst of this growing uncertainty, NLDCs were faced with the need to refinance a huge amount of debt—both medium-term loans from the mid-1970s and short-term credits extended in 1980-1981—and to obtain new financing. In this uncertain environment, however, commercial banks became increasingly cautious about continued lending without some program to deal with the underlying NLDC economic problems.

This change both in perceptions and in reality became a crisis in August of 1982 when Mexico announced that it could not meet debt service payments due that month. Argentina, with its exports curtailed and its finances disrupted by the Falklands War, reached the same situation shortly thereafter. Despite its considerable progress since 1980 toward fundamental adjustment, Brazil found itself caught up in the general uncertainty about lending to Latin America. It began experiencing difficulties in raising additional financing and, by December of 1982, began negotiations with the International Monetary Fund (IMF) and its commercial lenders. Within four months, the three largest NLDC borrowers from U.S. banks were forced to seek rescheduling and assistance.

The basic problem we now face is that a number of debtor countries have not been able to adjust quickly enough to rapidly changing economic conditions, and are having difficulties in making payments on their external loans and arranging financing from private capital markets.

An attendant problem is that a number of our major banks have large exposures to the countries that have become higher risks. More specifically, a number of U.S. banks have exposures exceeding 50 percent of capital to Mexico, Brazil, and/or Argentina. Losses resulting from the highly unlikely event of a total default by one of these countries would severely reduce the capitalization of those banks. At a minimum, such a loss of capital would force those banks to greatly contract their lending activities—domestic and foreign.

The loss of confidence that would result from a default would magnify these consequences. Unlike smaller banks, all large U.S. banks are heavily dependent for funds on the money markets; they do not have large core deposit bases. As a group, these banks depend on volatile liabilities (less than one year in maturity) for approximately 65 percent of their funding. One common source of such funding is large certificates of deposit; some 40 percent of these funds have even shorter maturities of 30 days or less. Thus, large banks are vulnerable to very rapid withdrawals of funds if financial markets lose confidence in them. Such a loss of funding could pose a serious threat to the banks and to both domestic and global credit markets.

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Responses to NLDC Debt Problems

The solutions to these problems are twofold. In the short term we must reduce the risk inherent in the existing exposures; that is, the large debtor countries must be restored to economic health. We cannot immediately

reduce the exposure itself for to do so would merely compound the economic problems faced by those countries Both official and commercial bank responses, in the form of financial assistance, debt rescheduling, and economic adjustment programs, are needed in order to accomplish this goal.

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Supervisory and Bank Response

Both bank supervisors and bankers themselves need to strengthen their procedures. In order to understand how that can be done, it is necessary to understand how our present supervisory system works.

Current Supervisory Process

The present system developed as a logical extension of our domestic supervisory policies and evolved as U.S banks expanded their lending activities overseas. The OCC began examining the overseas units of national banks in 1965 and today sends about 80 examiners to 15 countries every year. In 1972, we opened a London office to deal with the lending and money market activities of U.S. banks. In 1973, we began requiring all national banks to file reports of condition on a global consolidated basis. We began a uniform review of country risk in 1974. In 1977, we implemented what became the present Country Exposure Report, along with more comprehensive examination policies and procedures for supervising international activities. Supervisors in other countries have adopted these procedures for use with their own banks.

Since 1977, the supervision of U S. banks' international activities has become more uniform. For instance, the Country Exposure Report has been adopted by all three banking agencies under the guidance of the Federal Financial Institutions Examination Committee (FFIEC). A number of changes have been introduced to the Report of Condition and Report of Income so that all U S banks now file uniform reports of their international assets, liabilities, and income to the banking agencies The banking agencies have all adopted common examination procedures for foreign exchange and international operations. Finally, the FFIEC now sponsors uniform training in international bank supervision.

In 1978, the OCC developed the so-called "means and purpose test" for applying lending limits to sovereign borrowers. In 1979 the three banking agencies established the Interagency Country Exposure Review Committee [illegible] to evaluate transfer risk and incorporate [illegible] bank supervision. These last two [illegible] part of our international [illegible] today.

Means and Purpose Test. The means and purpose test was developed in response to continued growth in international lending By 1978, loans to foreign governments, such as the U. K. and Italy, were nearly 10 percent of some banks' capital. That growth presented two problems. First, the statutory lending limit in 12 U.S.C. 84 was silent on loans to governments. Second, many countries had mixed economies in which the government controlled commercial entities. For such countries, it was not clear whether loans to those entities should be aggregated with loans to the government for purposes of the legal lending limit.

The OCC addressed both these problems by issuing an interpretation of 12 U.S.C. 84. First, OCC interpreted the law that a government is considered a person for lending limit purposes. Congress recently incorporated this interpretation in the Garn-St Germain Act.

Second, the interpretation set forth a means and purpose test under which a state-owned company could qualify for its own lending limit apart from the government if it used the loan for its own clearly separate purposes and had independent means with which to repay the loan. Finally, as is the case domestically, the legal lending limit is applied separately to each private sector borrower in each country.

The result is that the means and purpose test in 1978 closed a significant "loophole" in the lending limit statute (the law's silence with regard to the treatment of sovereign borrowers). It did not, however, impose an overall limit on exposures to any one country.

Both the legal lending limit and its means and purpose interpretation with regard to sovereign borrowers deal with the aggregation of loans. They do not deal with the evaluation of any particular source of risk to those loans, or the degree to which the bank's overall portfolio may be exposed to those risks. The interpretation reflects the domestic application of the legal lending limit. For example, the lending limit applies to individual agricultural borrowers. There is no limit on a bank's overall concentration in agricultural lending, however, and in many farming communities those concentrations directly and indirectly represent most of the assets in many community banks. Banks with such concentrations may be significantly threatened by the risk of illiquidity in their loans under depressed agricultural economic conditions, even though those loans may be secured by sound collateral.

Similarly, no aggregate limit is placed on country lending even though such lending exposes banks to an additional form of liquidity risk, known as "transfer risk." Transfer risk exists when loans made in one country are denominated in the currency of another country—that

is, an entire country may not be able to generate adequate foreign exchange to permit the servicing of individual loans.

Interagency Country Exposure Review Committee. The purpose of ICERC is to assess and ensure uniform classification of transfer risk and to communicate that assessment to banks and examiners. ICERC is comprised of senior examiners from the three banking agencies; it performs two functions:

- Data gathering: ICERC conducts a semiannual country lending survey through the FFIEC to obtain information on U.S. bank exposure to individual countries. When exposures to individual countries change by billions of dollars quarterly, as occurred in 1982, semiannual information forms an inadequate basis for credit decisions by banks and supervisory decisions by regulators.

- Transfer risk evaluation: ICERC evaluates the potential transfer risk in countries where U.S. banks lend. ICERC classifies loans when they become non-performing as the result of transfer risk. ICERC evaluations and classifications are sent to banks and examiners for use in examining individual banks.

ICERC decisions are based on information and data from the banks, the Federal Reserve Board, and the Treasury Department about the existing debt structure of a borrowing country. Generally, the data and information used by the banks and ICERC has been adequate for loan classification decisions. However, information on balance of payments and macroeconomic conditions can lag behind events and may not always be complete. Sufficient information about short-term debts, especially for the private sector, is not always available. This deficiency has become a problem during the recent build-up of short-term international loans and the changing expectations about some countries' future flows of foreign exchange.

Bank examiners present ICERC's evaluation of transfer risk in their reports of examination to the bank's directors. The exposure is shown in dollar amounts and as a percentage of the bank's capital. Examiners also highlight large concentrations of transfer risk, even when the loans are still current. In 1981, we began emphasizing transfer risk classifications and concentrations as a specific agenda item during regular meetings with bank boards of directors. But, and as reported by the General Accounting Office, the presentation of ICERC evaluations could have been more forceful and clear in its purpose, more uniformly implemented by the agencies, and more influential on management's international lending decisions.

Proposals to Strengthen Supervision

U.S. bank supervisors and bankers themselves can and should take steps to strengthen lending procedures in order to reduce the future likelihood of accumulating large high risk exposures overseas. Those steps should ensure that banks at least do not profit from difficulties that may arise and, in fact, may pay a penalty. The steps also should involve increased incentives or regulations to avoid excessive concentrations. While developing countries will continue to need additional bank credit in the future, banks will have an equally important need to avoid excessive international exposures.

We have been working with the Federal Reserve and FDIC to develop a way to strengthen supervision of international lending. A joint memorandum outlining a five-point program was provided to the banking committees in both houses of Congress on April 7.

The objective of the program is to encourage the banks to make prudent international lending decisions. It is based on two fundamental principles of banking—diversification of risk and the maintenance of adequate financial strength to deal with contingencies. The program promotes earlier recognition of international lending problems, encourages orderly responses to these problems, and provides for strong reserves should severe problem loans develop. The program is an integrated package—all elements are necessary to accomplish the objective.

The program elements are:

1. Strengthening of Country Risk Examination and Evaluation. The federal banking agencies must strengthen the ICERC process and the manner in which the ICERC evaluations are used in examining individual banks. Specifically, we intend to:

- *Get management's attention.* In some cases, supervisory concerns about country risk and exposure levels have not been communicated to the highest levels of a bank, clearly, forcefully, and uniformly. We intend to correct this problem by stating our concerns more explicitly and by highlighting those concerns more assertively in our reports of examination, transmittal letters, and meetings with boards of directors

- *Strengthen capital requirements.* If a bank decides to carry relatively large concentra

tions of exposure in a particular country, the regulatory agencies will expect those banks to maintain a higher level of capital.

2. Additional Reporting and Disclosure. To meet supervisory needs, the banking agencies propose that banks report their transfer risks quarterly instead of semi-annually. Although this reporting would impose an additional burden on banks, such information is necessary to better monitor international exposures.

The money and capital markets also need more frequent, more uniform, and more detailed information about the international exposures of U.S. banks. Therefore, such information should be made available to the public. We propose to achieve this disclosure through appropriate additional requirements in the FFIEC Country Exposure Report.

3. Prudential Reserves for Problem Loans. Some U.S. banks are not realistically recognizing the value of foreign loans with protracted repayment difficulties. We believe banks should adjust the value of such assets, rather than carrying them on their books at full value. For that reason, the banking agencies propose to establish a reserve policy for the uniform treatment of such loans.

Under such a policy, special reserves would be established for loans on which the borrower has demonstrated protracted debt service problems. Evidence to that effect would include the following factors. (a) full interest payments had not been made, (b) the terms of rescheduling agreements had not been met, (c) International Monetary Fund (IMF) programs had not been complied with and there was no immediate prospect for such compliance, or (d) no definite prospects existed for the orderly restoration of debt service. The reserve would be charged against income in an amount to be determined by the bank regulatory agencies each year and would not be considered as capital and surplus. We would establish this reserve mechanism through appropriate changes to our Consolidated Report of Condition and Income.

4. Changes in Accounting for Fee Income. Neither generally accepted accounting principles nor bank regulatory reporting requirements specify how loan fees should be recognized as income. Fees received in conjunction with international credits, including reschedulings, typically represent both expense reimbursements and yield adjustments. The only portion of a fee that should be taken into current income should be the amount that represents costs directly incurred in putting the loan together. Otherwise, current income may be overstated and an inappropriate incentive to lend would be maintained. For that reason, the banking agencies are prepared to amend their Report of Income and establish rules to require banks to more realistically recognize fee income.

5. Stronger Cooperation With Foreign Bank Supervisors and the IMF. The interdependence of the international financial system requires the coordination and harmonization of our efforts with those of bank supervisors in other countries as well as with the IMF.

- *Cooperation with other supervisors.* Such cooperation can reduce competitive inequities by facilitating more consistent treatment of all international lenders. It will also increase the effectiveness of our efforts with U.S. banks.

  The systems of bank supervision in other countries are operationally different from ours. The differences reflect differences in convention, form of government, and the attitudes toward bank supervision. However, international generally accepted accounting principles are followed in the world's major banks. Policies for income recognition and reserves for troubled loans generally have been established by banking authorities. Most countries have elaborate systems of bank supervision, including on-site examinations. But no other country requires the degree of public disclosure of banks' activities that we require for U.S banks.

  There is broad consensus among countries about what needs to be supervised. Bank supervisors in the G-10 countries and elsewhere believe that banks should be supervised on a worldwide consolidated basis and that no international activities by banks should escape supervision.

  In addition, bank supervisors have set supervisory standards for banks' activities in three areas: foreign exchange dealing; monitoring foreign exchange and liquidity positions; and consolidating and evaluating country exposure.

  These principles of supervisory responsibility are spelled out in the Concordat of the Committee on Bank Regulation and Supervisory Practices at the Bank for International Settlements in Basle, Switzerland. The Concordat deals only with supervisory responsibilities, it does not include any lender of last resort responsibilities. The Committee is comprised of central bankers and supervisors from the

G-10 countries and Switzerland. The OCC has been a member of this committee since 1978.

- *Cooperation with the IMF.* The IMF can play an important role in strengthening overall supervision of international credit. The Fund has access to data on the external borrowing of its member countries. Therefore, it could help banks and their supervisors by publishing more international lending information and by placing limits on public sector borrowing of countries undertaking IMF programs.

Proposed Legislation

The federal banking agencies believe they can implement this five-point program under existing authority, including the Financial Institutions Supervisory Act of 1966. However, Congress may wish to specifically indicate that this authority exists and should be used in the areas covered by our program. To that end, on April 15, we submitted a draft proposal for congressional consideration. That draft suggests broad legislation to clarify and strengthen our existing authority to implement the five-point program. We continue to believe it would be undesirable to establish inflexible or inconsistent statutory rules that could limit the agencies in adapting the program to market and environmental changes as they occur in the future.

Although it has been suggested that the FFIEC should have a greater role regarding international lending supervision, we strongly disagree. Cooperation and coordination among the agencies has been substantive and excellent as far as establishing policies, practices, and procedures for international supervision.

Finally, we are opposed to establishing country lending limits. The concept of putting a ceiling on a bank's total exposure to individual countries appears to be a simple, direct solution to current international lending difficulties. However, country lending limits are neither a practical solution for immediate problems nor a desirable mechanism to deal with the problem of transfer risk over the long term. This is true for a number of reasons.

It would be very difficult to shift bank portfolios from today's composition to one that would conform to any meaningful limit. A basic decision would have to be made on how to set the limits It would be politically and diplomatically difficult to set different limits for different countries. Therefore, we must assume that there would be one limit, probably based on bank capital, for every country. A number of major U.S. banks, however, have large exposures in one or more countries. Much of this credit has been extended to countries that are not experiencing economic difficulties. For example, a number of banks have exposures to Canada, Japan, the U.K., and other industrial countries well in excess of 100 percent of capital. Imposition of uniform country lending limits would require banks to reduce these exposures as well as those to more troubled borrowers.

The consequences of reduced credit flows to these countries, which include our allies and trading partners, clearly would be undesirable. These countries might find it necessary to replace this capital shortfall by pulling their loans and investments out of the United States.

A complete curtailment of future credit flows to the NLDCs, much less an absolute reduction in current exposures, would be no more desirable. Such action would seriously impede the ability of NLDCs to generate sufficient economic growth to repay loans from U.S. banks or anyone else.

It is difficult to justify absolute limits on transfer risk without at the same time limiting other concentrations of risk, including lending to particular domestic sectors or geographical regions. I would not favor those types of absolute limits either. On balance, then, I believe it would be inappropriate to impose country lending limits on U.S. banks.

Conclusion

U.S. banks' foreign loans present significant problems both to banks and to bank supervisors. However, I believe these problems are manageable.

It is not possible or desirable to make immediate reductions in the U.S. banks' exposures overseas. To do so would cause an immediate credit contraction and precipitate the very crisis that we are all working to avoid.

Instead, what is needed is the extension of additional credits to meet the pressing needs of borrowing nations pending adjustment and the restoration of economic growth. These efforts have been coordinated and must continue to be carried out by all interested parties: multilateral agencies, Western governments, banks, and the borrowers themselves. To that end, we strongly support an increase in IMF quotas and the General Arrangements to Borrow (GAB)

At the same time, we need to strengthen our supervisory procedures. We intend to take the following actions:

1. Improve country risk examinations and evaluations and strengthen the link between loan concentrations and capital,

2. Require improved information and disclosure about U.S. banks' exposures overseas;
3. Require special prudential reserves against loans to countries with a history of protracted payment difficulties;
4. Change the accounting treatment of fees for international loans so that they are taken into income over the life of the loan; and,
5. Coordinate our efforts with those of bank supervisors in other countries and with the IMF.

Ultimately, the condition of U.S. bank loans overseas is a function of the state of the worldwide economy. Banking is, by its very nature, the business of taking risks. Inevitably, there will be countries in the world that are experiencing economic difficulties, and U.S. loans to those countries will reflect those problems.

Today, we are recovering from a worldwide recession that has taken a heavier than expected toll on U.S. bank loan portfolios, both domestic and international. Our ultimate goal, therefore, must be to restore stable, non-inflationary economic growth throughout the world and to maintain a free and open international trading and financial system. Our efforts to improve bank supervision and those of our counterparts throughout the world must be carried out within the context of that goal.

Statement of C. T. Conover, Comptroller of the Currency, before the House Committee on Banking, Finance and Urban Affairs, on Continental Illinois National Bank and Trust Company, Washington, D.C., September 19, 1984

Mr. Chairman, members of the committee, I am pleased to be here to discuss Continental Illinois National Bank and Trust Company (Continental). The serious problems encountered by Continental and the regulators' actions concerning Continental are obviously a matter of public concern and deserve a thorough review by Congress and the public. It is my hope that these hearings will generate a broader understanding of the bank regulatory process, and the events surrounding the financial deterioration of Continental and the ensuing federal assistance. I would like to express my appreciation to the members of the Office of the Comptroller of the Currency (OCC) staff as well as the other financial regulatory agencies who have devoted countless hours in working toward a resolution of Continental's difficulties.

In the spring of 1984, Continental began experiencing liquidity problems that reached crisis proportions in May. The liquidity problems resulted from a rapid decline in market confidence brought about by severe deterioration in the quality of Continental's loans.

On May 17, a temporary assistance program was implemented by the federal regulators to allow time to work out a solution while minimizing any adverse impact on global financial markets. The long-term solution, which was announced July 26 and on which shareholders will vote on September 26, is intended to restore Continental to health and allow it to continue to serve its marketplace without interruption.

I fully appreciate the committee's need to receive full and complete information on this office's supervision of Continental. For that reason, we have provided the committee's staff complete access to all OCC documents relating to the condition of Continental and our supervision of the bank. At the same time, we have been careful to protect the legitimate rights to privacy of bank customers and other third parties. I hope that these hearings will also contribute to the committee's understanding of what happened at Continental.

There are many important aspects to the Continental situation that need to be aired at these hearings. I can best contribute to the process by focusing on the bank itself, and this office's supervision of it. I understand the Federal Deposit Insurance Corporation (FDIC) will discuss the temporary assistance plan and subsequent long-term solution. Similarly, the holding company, Continental Illinois Corporation, and certain aspects of the federal assistance plan are more appropriately discussed by the Federal Reserve Board.

Today, I will address what happened at Continental by first describing the economic factors that have buffeted Continental—and other banks—since 1980. These include back-to-back recessions as well as a sharply declining energy industry. Second, I will briefly review the internal policies and practices at Continental that rendered it incapable of weathering these adversities. Fundamentally, the bank undertook an aggressive growth strategy without adequate safeguards against the ensuing adverse events. Third, I will discuss what we could have done differently. Finally, I will focus on what we are doing to assure the continued safety and soundness of the banking system. The Appendix includes a 10-year chronology of Continental's internal policies, strategies, and decisions; describes the prevailing economic environment; and details this office's supervisory involvement with the bank.*

Economic Problems Have Impaired Bank Performance

The 1980s have been difficult years for the banking industry. In early 1980, a recession caused real economic growth to drop sharply. By mid-1980 the economy was growing again, but that recovery only lasted 12 months. In mid-1981, the economy fell back into a recession that lasted 17 months. This latter recession proved to be deep and pervasive, with virtually no sector of the economy left untouched. It was a particularly difficult recession because, unlike most, it was not accompanied by declining real interest rates.

Although the economy as a whole is now experiencing a strong recovery, the pattern of back-to-back recessions was particularly hard on lending institutions. Loan quality typically begins to deteriorate after an economic slowdown begins, and continues to decline well into the recovery. When the 1981 downturn occurred, banks were still dealing with increasing loan losses from the 1980 recession. The second downturn not only added new problem loans, but hindered attempts to work out existing problem loans. Many loan portfolios, thus, have continued to deteriorate since 1980, and many banks are still having problems stemming from the recessions

**The appendix has been omitted. It can be found in volume 3, number 4, pages 27-36 of the Quarterly Journal.*

In addition to having to contend with the effects of the two recessions, many banks have also been affected by the severe problems in the energy industry over the last few years. Oil prices began to drop sharply in early 1980. Although they rose again during the last half of 1980, by 1981 oil prices were clearly on a downward spiral. This caused a sudden and unexpected decline in the profitability of energy exploration and production in late 1981. Banks that had lent money to a booming industry suddenly found many of their customers facing severe financial difficulty, and in many cases, bankruptcy. The energy sector continues to be a problem area for lenders today, as oil prices continue to soften.

These economic factors have posed challenges to all bankers. In an earlier era of strong domestic and international economic growth and relatively stable interest rates, bank managements' abilities were not sorely tested. However, over the last few years, the margin for error in banking has shrunk dramatically.

Most U.S. banks have weathered these difficulties with impressive resilience, but almost all have felt some impact. Return on assets and return on equity are down for the industry as a whole. Asset quality is still suffering, with net loan losses rising even faster for large banks than for small.

One important consequence of the industry's problems has been a heightened public concern about the condition of U.S. banks. Market confidence is an unpredictable but crucial element in the stability of individual banks and the banking system as a whole. Whether a bank survives adverse circumstances is often a matter of whether the market allows it the needed time to work out problems. In the case of Continental, the market didn't provide this needed time.

What Happened at Continental?

The difficult economic environment had a particularly devastating effect on Continental. Its problems stemmed from management strategies and policies that depended on strong growth in the economy in general and the energy industry in particular. These strategies and their consequences are detailed in the appendix to this testimony. In sum, Continental adopted a policy of rapid growth that was not accompanied by the necessary management controls and policies to maintain adequate asset quality in the face of an economic slowdown and a declining energy industry.

Management Strategy Showed Early Signs of Success

Continental's management announced its decision in [illegible] lending to "Corporate America." Located in the heart of industrial America, Continental was already the leading commercial lender in the Midwest. Moreover, because it could not establish a significant retail customer base due to state restrictions on branching, the bank's corporate lending function was a natural area for expansion. Continental set out to quickly become a major lender to corporate customers.

In implementing this goal, Continental adopted a strategy of decentralized lending that permitted its account officers to respond to customers and make loans more quickly and competitively. Although this approach required fewer controls and levels of review, management believed the potential rewards of such a strategy outweighed the associated risk. Management felt confident about the depth and experience of the bank's staff and its analysis of the direction of the economy. Obviously, this judgment proved to be incorrect.

Continental's management targeted the energy sector for its most aggressive lending expansion. During the latter half of the 1970s, the United States was attempting to develop a program for energy self-sufficiency in the face of uncertainty about actions of the OPEC nations. The 1973 oil embargo had propelled energy independence to the forefront of our national goals. Prices were skyrocketing and gas lines were forming when Continental targeted energy lending as an area for growth. The federal government was giving serious consideration to gas rationing and even printed one million rationing coupons.

The Administration and Congress in 1977 emphasized the critical nature of energy to the United States by establishing a separate Department of Energy. At that time, some economic analysts were projecting the price of oil to increase to some $60 a barrel. In June 1980, Congress enacted the Energy Security Act establishing the Synfuels Corporation and authorizing $20 billion for synthetic fuels development.

Continental's management strategy of rapid growth with a specialty in energy was quite successful for several years. During the late 1970s, Continental outperformed its peers in growth, earnings, and market perception, and its loan loss record was excellent. In 1978, *Dun's Review* described Continental as one of the five best managed companies in America.

Asset Quality Ultimately Deteriorated

In 1981, the very strategy that generated praise began to turn against Continental. A slowing economy meant that the quality of available lending opportunities was deteriorating at the same time that Continental was increasing its corporate lending, inevitably resulting in

the making of loans to weak borrowers. In addition, many of Continental's existing corporate borrowers were seriously affected by the back-to-back recessions; existing loans to these companies became problems. By 1982, it became clear that the bank's rapid growth had been achieved at the expense of asset quality.

The declining energy industry in late 1981 dealt a particularly serious blow to Continental. The end of the energy boom put a severe strain on the bank's energy producing borrowers. Many of Continental's energy loans, which had been performing well and had been extremely profitable, suddenly turned into serious collection problems.

Continental's problems in the energy area were twofold. First, it had a heavy concentration in oil and gas loans that left the bank extremely vulnerable to the industry's sudden decline. Since July 1982, oil and gas loans have accounted for approximately two-thirds of the bank's losses, although those loans have averaged only about 20 percent of the total loan portfolio.

Second, from 1980 to 1982, the bank had purchased a large volume of energy loans from Penn Square Bank, N.A. The quality of these loans proved to be very poor, particularly those loans that were purchased in late 1981 and early 1982 when Continental's growth was peaking. Loans purchased from Penn Square constitute a disproportionate amount of Continental's losses. During our May to November 1982 examination, for example, Penn Square loans accounted for approximately 3 percent of all Continental's loans. However, they accounted for 16 percent of classified loans and 65 percent of the charge offs directed by our examiners.

Inadequate Management Controls Permitted Huge Losses

Considering the disproportionate contribution that Penn Square loans made to Continental's losses, it is important to analyze how such a questionable relationship could develop in a bank that had been a top performer for so many years. It now appears that Continental's purchase of problem loans from Penn Square involved significant misconduct on the part of officers of both institutions. There are also indications that criminal fraud may have been involved. In fact, on September 10, 1984, William G. Patterson, the former head of Penn Square's energy lending division, was brought to trial on a 34-count indictment that charged, among other things, that he engaged in deceitful and fraudulent conduct to conceal his illegal banking practices from OCC examiners and the banks that purchased loans from Penn Square.

However, the problem extends beyond employee misconduct. Management processes should be in place to guard against and detect employee misconduct as well as other risks. These include policies and controls governing loan approval, review, and classification; mechanisms for determining provisions for losses; loan workout functions; management information systems; and loan officer compensation systems. For banks such as Continental that undertake aggressive growth strategies, top quality controls are essential.

Continental's management controls were the subject of considerable attention in our examinations over the past eight to ten years. Although we judged the bank's system of loan controls to be generally satisfactory, we directed a number of specific improvements. For example, we cited, at various times during the period from 1974 to 1981, problems with the past-due loan report, the completeness of credit files, the identification and rating of problem loans, and collateral deficiencies. Bank management was generally responsive to our concerns and made a number of improvements in its systems for controlling and detecting risk in the loan portfolio.

These improvements were not enough. In retrospect, it is clear that there was not sufficient management support for the control systems. Top management had created an environment where aggressive lending was not only condoned but encouraged. In this atmosphere, a high quality system of controls was secondary. Moreover, those warning signals that the existing system did generate were ignored by senior lending officers.

In the final analysis, the bank's internal controls did not prevent the purchase of massive amounts of bad loans from Penn Square. With the benefit of hindsight, it is clear that our generally favorable assessment of Continental's internal controls was overly influenced by the bank's outstanding performance during the years 1974 through 1981.

Continental Was Dependent on Volatile Funds

Although Continental was weakened by asset deterioration, its losses never exceeded capital, and thus it never reached book insolvency. Rather, its near-collapse was triggered by funding problems. Beginning in the second half of 1982, the bank was forced to rely increasingly on foreign funding, as federal funds and certificates of deposit rapidly eroded. For almost two years, the overseas funding provided Continental with relatively stable, much needed liquidity. It also made the bank vulnerable to the liquidity problems that occurred in May 1984 when uncertainty about Continental's condition caused the overseas markets to close completely.

Clearly Continental's reliance on uninsured, short-term funds meant that it was particularly vulnerable to a loss of confidence. However Continental's earlier decision to become a major corporate lender made the wholesale market a natural funding source. The wholesale market was practically a necessity given the restrictive branching statutes in Illinois that made establishment of a broad retail customer base difficult.

Although reliance on uninsured, short-term funds makes a bank sensitive to market perceptions, it is not by itself an imprudent banking practice. If a bank maintains sufficient liquidity and asset quality, periodic shortfalls in funding can be readily accommodated.

In Continental's case, the heavy reliance on wholesale funds was not accompanied by enough liquidity to sustain it through funding shortages. The bank's aggressive lending strategy was pursued to the exclusion of sufficient liquidity, resulting in a higher proportion of loans relative to assets than any of its peers. Even an extremely conservative liquidity position would not have protected Continental from the major funding crisis it experienced last spring. Nevertheless, it is an area we could have paid more critical attention to; we are doing so in large banks now.

Continental Never Regained Lost Confidence

It became clear, during our examination that began in May 1982, that Continental's management practices and policies had led to serious loan problems. We responded to this in a number of ways. We extended our examination through November. During the course of the examination, we directed Continental to begin a number of corrective measures, which were immediately initiated by the bank. We informed management of our intention to formalize these directives by placing the bank under a formal agreement, enforceable under the cease and desist authority of 12 USC 1818. My staff and I met several times with senior management and board members over the next few months to discuss the bank's condition and the impending agreement.

The agreement required improvements in numerous areas, including loan policies and procedures, asset and liability management, and funding. It also required regular reports by a board committee on the bank's compliance with the agreement. Bank management complied with the terms of the action and took significant steps to revamp its operations. However, the loans that crippled Continental were already on the books.

Market confidence had begun to turn against the bank in July 1982, when its Penn Square loan problems [illegible] OCC supervision and presence in the bank over the next two years, and the efforts by bank management and the board of directors, Continental was unable to fully regain market confidence. In May of this year, the market reacted adversely to rumors of further problems at Continental, and large depositors began withdrawing funds. The bank was unable to stem the run, and federal intervention was required to prevent the bank's collapse.

What Could Have Been Done Differently?

An obvious question that we and others have asked is whether there was anything that the OCC should have done differently in the course of Continental's deterioration. In addressing this question, it is important first to clarify the role of the bank supervisor.

The Supervisor's Role Is to Maintain Systemic Soundness

Short of nationalizing the banking system, no bank regulatory system can prevent all bank failures. I do not believe that the American public would support either the cost or the kind and degree of regulation and supervision that would eliminate all possibility of failure. To do so would require removing all risk-taking from banks, and would make banks unable to carry out their role as financial intermediaries in fueling the nation's economic growth. At the same time, however, it is clear that the nation is not well-served by a banking industry where the potential for failure is unrestricted.

Our charge is to maintain the safety and soundness of the national banking system. To do so requires sufficient oversight of and interaction with bank management to minimize the likelihood of bank failure. We do not take over and manage institutions, we cannot substitute for private management in making lending or any other decisions. The primary responsibility for any bank's performance rests with its management and board of directors. However, as supervisors we do monitor risk exposure, work to see that policies and controls are appropriate to that level of risk, and enforce compliance with the law. When we identify major weaknesses, we institute corrective measures, and follow up on their implementation. This results in significant improvement in the vast majority of institutions that we identify as having problems.

For some institutions, even prompt and stringent corrective measures are unsuccessful. The safety and soundness of the banking system also requires allowing such poorly managed, financially weak institutions to disappear from the system in an orderly manner. In an important sense, this is what has happened to Continental. The doors are still open, but the officers who allowed the bank's deterioration are no longer part

of Continental. Moreover, those that bear responsibility for approving management policies have paid a price. The shareholders face substantial if not total loss, and the directors and former management face potential legal liability.

Could the OCC Have Taken Other Actions?

The demise of Continental was clearly not desirable. It would have been far better if management had made better decisions and taken actions that would have been more appropriate for the ensuing circumstances. It would also have been preferable if we as supervisors could have done something to change the course of Continental.

As we review the history of Continental, it is possible to identify several points in time and ask whether it would have been appropriate for the supervisors to step in forcefully to change the course of the bank's direction. We did this, of course, after our 1982 examination when we took a formal enforcement action against the bank. Most banks, including Continental, respond to this type of corrective measure. What made Continental different from most of these cases was that the market did not wait for the bank's recovery plan to restore it to health.

I am persuaded that since mid-1982, there was nothing more that we could have done to speed Continental's recovery and thereby increase market confidence. One possible action was to force out top management in addition to those dismissed following the failure of Penn Square. We decided not to do this, for several reasons. First, existing management had proven more capable than most at bringing the bank out of the serious difficulties that many large banks faced following the REIT problems of 1975 and 1976. Second, management recognized the bank's problems in 1982 and put a program in place to identify and correct them. Finally, a thorough, independent management review undertaken by the board of directors in mid-1982 had indicated which officers had been directly responsible for the Penn Square loans, and those officers were removed.

One other possibility would have been to force the bank to curtail dividend payments. However, management and the board of directors felt that maintaining dividend payments was crucial to regaining market confidence and to raising additional capital. Moreover, the amount of money involved would not have added appreciably to capital. In all, once the bad loans were on the books, OCC—and the bank—took every action that could have been reasonably expected to restore Continental to health.

We have asked ourselves whether we should have taken action as early as 1976 to prevent Continental from embarking on a course of rapidly becoming a top lender to corporate America. In my view, it would have been inappropriate to have done so. It is not the proper function of regulators to decide what business strategy an individual bank should undertake. The regulator's role is to see that whichever business strategy a bank chooses, it has the mechanisms in place to implement that strategy in a safe and sound manner.

In retrospect, it is clear that management, buoyant with the bank's years of financial success, placed too little value on risk control mechanisms in the implementation of its strategy. Continental's record shows that neither financial success nor the esteem of the financial community that flows from that success can substitute for sound and effectively enforced controls.

If there is anything that OCC could have done differently, I believe it would have been to place more emphasis on our evaluation and criticism of Continental's overall management processes. Had we done so, we might have been alerted to management's lack of commitment to controlling risk sooner than 1982. Had we been less swayed by management's successful track record from the early 1970s through 1981 and its previous responsiveness to our supervision, we might have been able to see more clearly the risks inherent in its rapid growth strategy.

Safety and Soundness Must Be Maintained

Continental's demise has highlighted the need for banks and supervisors to continue to work to maintain the public's confidence in individual banks and the banking system as a whole. All reasonable steps must be taken to strengthen the ability of banks to weather adverse circumstances and thereby earn the continuing confidence of depositors. I would like to focus briefly on seven areas where the OCC has taken steps to enhance its examination and supervision and to strengthen the banking system.

1. Supervisory Techniques Continue to Be Improved

The OCC's supervisory process has continued to improve as technological innovations have been made and industry conditions have changed. In the aftermath of Penn Square's failure and the problems experienced since mid-1982 by Continental and other banks, we have made a number of improvements in our supervision of national banks generally, and of large banks in particular

Our supervision of banks of all sizes has been enhanced by the establishment of an Industry Review Program. This program includes a computerized information system to collect data on industry concentra

tions in individual bank portfolios and the banking system as a whole. Through the use of outside information sources we are monitoring significant industries in an attempt to better anticipate developments that might result in problems for banks. Our examiners will use the information in their analyses of individual banks to identify concentrations and to help position banks to withstand problems emerging from them.

Industry analyses and developments will be available to each examining team through its own portable microcomputer. Each team is being provided with extensive training in the full range of analytical techniques and will be equipped to perform more sophisticated analyses of banks' activities than were possible previously.

The near-complete development of two additional computer systems will provide us with a much improved ability to respond to examination needs and follow up on examination results. The first will facilitate examination scheduling by establishing system priorities. The second is our Supervisory Monitoring System, an automated tracking system that provides our examiners with access to all supervisory information sources, particulary examination findings and recommended actions. This will require a more orderly tracking and efficient follow-up of important supervisory concerns.

We have also taken steps to ensure communication within the OCC of examination findings on individual banks that may affect other banks in the system. These steps include changes in OCC internal procedures, examination manuals, and training. A newly developed course for evaluation of problem banks, in particular, addresses this concern.

Our multinational bank program has been expanded and we are examining multinational banks more frequently than in the past. Our examinations are targeted on the areas of supervisory concern and take place two to three times a year, rather than annually. Moreover, we have reorganized and significantly increased our resources committed exclusively to the supervision of our largest banks. A corps of our best and most senior examiners has been devoted solely to supervision of the multinational banks. In addition to the more frequent examinations we have undertaken, the examiners will also monitor trends and developments in the banks between examinations. This new approach results in near-constant supervision of each of our large banks.

We are now better able to identify and devote attention to items of supervisory concern in individual large banks and [illegible] practices emerging in the large bank [illegible]. We are committed to continually improve our supervisory process and to maintaining an examination force that, in its training, support systems and overall quality is of the highest caliber.

2. Internal Controls Must Be Emphasized

The OCC is placing more emphasis in the examination process on banks' internal controls and systems. This includes increased testing of control procedures and their application, and more stringent follow-ups to ensure that internal control deficiencies are corrected.

To accomplish this, we are focusing our examiners' attention on four basic control questions:

- What systems are in place to permit early detection of actions or trends that, if continued, might seriously affect the bank's condition;

- What actions are taken by senior management once adverse trends and deficiencies are disclosed;

- What individuals in the bank are in a position to materially affect the accurate recording of transactions; and,

- What safeguards are in place to mitigate the chance that individuals could conceal irregularities from their superiors, bank auditors, and examiners.

These questions are particularly important in the area of problem loan identification systems and will receive greatest attention in that area.

In 1983, the OCC issued specific procedures that banks must follow when they purchase loan participations. The circular spells out that the purchase of loans and participation in loans may constitute an unsafe and unsound banking practice in the absence of documentation, credit analysis, and other controls over risk. The circular also warns banks that the absence of satisfactory controls over risk is unacceptable and may cause the OCC to seek appropriate corrective action through enforcement actions.

3. Loan Loss Reserves Are Being Evaluated

Since the allowance for possible loan losses (APLL) is the first line of defense against loan deterioration, we are taking additional steps to assess the adequacy of a bank's APLL relative to the total risk in its portfolio. We are concerned that for some banks, increases in the APLL have not kept pace with increases in nonperform-

ing and classified loans. We are addressing this concern by developing more specific criteria for use by our examiners in evaluating the adequacy of reserves and by focusing our examinations of large banks to make sure that reserves are adequate

4. Capital Levels Are Being Increased

Congress reemphasized the critical role of capital in maintaining the safety and soundness of the banking system when it enacted in 1983 the International Lending Supervision Act that authorizes the banking agencies to enforce capital requirements. Under regulations proposed by the OCC and the FDIC, all banks, regardless of size, would be required to maintain a minimum ratio of primary capital to total assets of 5.5 percent. The implementation of this regulation will require over 200 national banks to raise a total of over $5 billion in new capital. The Federal Reserve has proposed similar guidelines on capital.

Stricter regulatory capital requirements will strengthen the trend towards stronger capitalization of the nation's largest banks. For example, in the first quarter of 1984 the average ratio of primary capital to total assets stood at 5.67 percent for the holding companies of the 11 multinational banks supervised by the OCC. This is almost 16 percent higher than the average level at those banks two years ago.

Adoption of this standard would not replace our supervisory evaluation of capital adequacy. Banks of all sizes will be encouraged to maintain higher capital levels. Furthermore, the OCC retains the right to impose higher ratios for banks whose circumstances necessitate a stronger capital base.

As another means of ensuring adequate capital, OCC will be scrutinizing each bank's dividend payout policies in light of its overall capital structure. We will not hesitate to restrict dividend payments when necessary.

5. Sources and Uses of Funds Are Being Scrutinized

The OCC is devoting more resources to monitoring regional and multinational banks' global funding. Banks will be placed under special surveillance if they are especially vulnerable to eroding market confidence or reliance on particular funding markets is deemed to be excessive. A key element in our increased supervision of funding is constant monitoring of the attitudes and concerns of market participants. Supervisory actions on individual banks will vary but, at a minimum, they are expected to include the development of alternative funding plans. In some cases, supervisory actions could also constrain growth. Finally, where we find a high volume of volatile liabilities, we will require a larger percentage of liquid assets.

6. Increased Financial Disclosure Is Being Promoted

The market's evaluation of the banking system depends, in large part, on the information that is publicly available. To enhance the credibility of bank financial statements and reduce the likelihood that the market will overreact to incomplete information, the OCC is considering requiring increased disclosure of information about banks. To that end, it is seeking public comments on increasing the disclosure requirements for banks via an advance notice of proposed rulemaking (ANPR).

The ANPR highlights questions such as what additional information is needed; who should have the responsibility of making information public; and how the integrity of financial statements used for disclosure should be maintained.

The OCC has also taken steps to enhance the accuracy of information that is already disclosed. Recently the OCC took enforcement actions against six major banks and required them to restate some of their financial information to eliminate "window dressing" that could mislead depositors, investors, and the regulatory agencies.

In addition, along with the Federal Reserve Board, the OCC issued a statement on June 11, 1984, reaffirming its policy on nonaccrual loans. Such loans must be placed on nonaccrual status (by virtue of being more than 90 days past due) on contractual dates and must be brought current before being returned to accrual status. Finally, we are continuing to work with other federal banking agencies and the Securities and Exchange Commission (SEC) to review additional means of improving bank disclosure.

7. Strict Enforcement Policy is Being Maintained

We have been utilizing our enforcement power more vigorously to correct violations of law and imprudent banking practices. For instance, last year we took 274 formal actions against national banks compared with 156 for the previous year and only 65 in 1978. These actions have been taken against banks of all sizes. We have outstanding enforcement actions against 17 percent of the banks with assets over $1 billion and 12 percent of the banks with under $1 billion in assets. Last year, we also imposed civil money penalties against 127 bank officials. To put that into perspective, in 1981 we imposed only 19.

Over the past last several years our enforcement actions have covered a wide variety of banking ac-

tivities. In the large banks alone, we have recently taken a number of enforcement actions following targeted examinations that found inadequate loan loss reserves. In one instance, we took formal enforcement actions against some 21 national bank subsidiaries of a regional company to prevent improper transactions among affiliates. In addition to numerous cases addressing problem assets, lending controls, capital and management, actions against large banks have also been directed at inadequate procedures governing banks' securities activities. Moreover, we have worked jointly in enforcement actions with the SEC and have made referrals to the SEC when it appeared that holding companies failed to make adequate disclosure of the OCC's enforcement actions on a subsidiary bank.

Conclusion

In summary, Continental pursued a growth strategy without adequate controls that proved to be its downfall in adverse economic circumstances. The bank has suffered the consequences. Management has been removed, and shareholders have incurred substantial losses. At the same time, we have avoided major disruption to the financial system. Upon implementation of the long-term solution, Continental will be well-capitalized and have stronger assets and management. It will be returned to private ownership at the earliest possible date.

We continue to focus our supervisory efforts on enhancing the ability of banks to remain sound even under difficult circumstances. Such action will strengthen the banking system and assure the continuing confidence of depositors.

Statement of Jonathan L. Fiechter, Director, Economic and Policy Analysis Division, before the House Subcommittee on Economic Stabilization, Committee on Banking, Finance and Urban Affairs, on the condition of agricultural banks, Washington, D.C., November 21, 1985

Mr. Chairman, members of the subcommittee, I appreciate the opportunity to talk to you about the condition of agricultural banks. As you are well aware, our agricultural sector is going through a difficult period and the problems experienced by farm borrowers over the last few years have had a direct effect on agricultural lenders. Both federal and private lenders have experienced a dramatic increase in the number of problem agricultural loans. We believe, however, that the credit quality problems currently facing agricultural banks are manageable and do not threaten the safety and soundness of the national banking system.

The Agricultural Sector's Problems

American agriculture is going through a difficult period. However, the problems are not universal among farmers. The problems of the agricultural sector are generally concentrated among farmers who highly leveraged themselves in the 1970s.

In the previous decade, the nation's farm sector enjoyed expanded production. Domestic sales grew steadily at an average annual rate of almost 9 percent. Exports increased almost 19 percent annually in response to a weak dollar and foreign production shortfalls. As a result of this growth, farm revenue expanded at an annual rate of 10 percent.

The improved income of farmers during the 1970s boosted expected returns on farm assets, and drove up land values. The enhanced net worth of farmers, combined with optimistic expectations of further increases in farmland and commodity prices, prompted many farmers to borrow heavily to expand. In many cases, heavy borrowing took place despite sluggish growth in cash flow. Between 1970 and 1981, both farm debt and the price of farm land quadrupled.

Beginning in the early 1980s, however, it became clear that earlier expectations about the strength of the farm economy would not be realized. The worldwide recession, an appreciating dollar, and the export policies of competing countries all contributed to a decline in agricultural exports. Furthermore, stagnant commodity prices, high real interest rates, and increased production costs led to a deterioration in farm profitability and diminished cash flow. As the expected returns on farming declined in the 1980s, the value of farmland also began to fall.

Most farmers, despite a less robust agricultural environment, have generally been able to meet their debt servicing requirements. According to Federal Reserve Board analysis of a 1985 USDA Survey of Farm Costs and Returns, presented in recent testimony before this subcommittee, 70 percent of commercial farm operators are considered to be in "good" financial condition. That is, 70 percent of these farmers have a favorable combination of income and equity cushion.

A minority of farmers, however, who heavily leveraged themselves in the 1970s, have inadequate cash flow to meet their higher debt servicing requirements. Debt servicing capacity declined considerably over the 1970s. By 1984, cash flow coverage of interest expense was one-third of what it was a decade earlier. The result has been a deterioration in farm credit quality, particularly for highly leveraged farmers.

According to USDA data of January 1985, farmers with debt-to-asset ratios in excess of 40 percent represent less than one-third of all farms, but owe almost two-thirds of all farm debt. The significant rise in problem agricultural loans and farm bankruptcies can be attributed primarily to this group of farmers.

These financial problems appear to be concentrated among mid-sized farms, those with annual sales of between $40,000 and $500,000. Many of these farms have experienced several consecutive years of operating losses making debt repayment difficult, especially for those that became overextended in the 1970s.

Commercial Bank Exposure to the Farm Credit Problem

The problems experienced by farm borrowers over the last few years have had a direct effect on a variety of private and public agricultural lenders. We do not believe, however, that problems in the agricultural sector have endangered the safety and soundness of the banking system.

The banking sector's direct exposure to the agriculture sector is limited to slightly over 2 percent of total commercial bank assets. The banking system holds approximately $50 billion in direct loans to the farm sector which is roughly one-fourth of the total farm debt

Half of the $50 billion in commercial bank credit to the farm sector is held by commercial banks with diversified loan portfolios. These include small banks that do little agricultural lending as well as large banks that have sizable agricultural loan portfolios but also lend in other areas. Because these banks are diversified, they are generally able to absorb the losses attributed to the deteriorating condition of agricultural credits.

The other half of the agricultural credit extended by the commercial banking system is held by 3,900 agricultural banks, defined as banks with over 25 percent of their gross loans in agricultural credits. Agricultural banks have average assets of about $30 million and are typically much smaller than non-agricultural banks. Although they comprise 27 percent of the commercial bank population, they hold less than 5 percent of the total $2.6 trillion in bank assets. These banks, 850 of which are national banks, have been the most susceptible to problems in the agricultural industry.

Primarily as a result of the growing credit quality problems with farm loans, the condition of national agricultural banks has deteriorated. An increasing proportion of national agricultural banks are problem banks (*i.e.*, have CAMEL ratings of 4 or 5). In mid-1983, 18 percent of problem national banks were agricultural banks. However, as of June of this year, agricultural banks accounted for 37 percent of problem national banks. This increase in the number of problem national agricultural banks accounts for most of the increase in the number of problem national banks over the past few years. Of the 26 national banks that have failed thus far this year, eight, or about one-third, have been agricultural banks.

As of June 1985, 157 national agricultural banks reported negative net income as problem loans continued to rise. National agricultural banks' ratio of median classified assets to gross capital funds reached 48 percent in June of this year. This was up from 35 percent one year ago and 28 percent two years ago. In contrast, the ratio for non-agricultural national banks has risen only slightly over the past two years from 20 percent in mid-1983 to 23 percent in mid-1985.

Furthermore, net loan losses, as a percentage of gross loans, have been rising for each of the past five years. In 1979, median net loan losses were less than .25 percent of gross loans. As of year-end 1984, however, median net loan losses as a percentage of total loans had risen to .75 percent.

The problems of many agricultural banks, while serious, should be kept in perspective. The majority of agricultural banks are healthy and viable. The typical agricultural bank, with a primary capital-to-asset ratio of 10.5 percent, continues to be better capitalized than its non-agricultural counterpart, which has, on average, a 9.5 percent primary capital-to-asset ratio.

This does not diminish the fact that the condition of a number of agricultural banks is poor and requires serious supervisory attention. We recognize the costs to a local community of any bank failure. However, we do not believe that the current number of bank failures nor the problems associated with the agricultural sector currently pose a threat to the confidence in, or the stability of, the commercial banking system.

Federal Policy Regarding Farm Credit Problems at National Banks

A number of the proposals addressing the agricultural situation have suggested financial and other assistance for agricultural lenders including commercial banks. We do not believe that federal assistance for commercial agricultural banks is necessary at this time. We believe that targeting assistance to those banks with large agricultural loan portfolios is undesirable from the point of view of public policy.

First, the assets of agricultural banks in difficulty are not a significant portion of the banking system. Moreover, the majority of these banks are in sound financial condition.

Second, we are confident that the problems facing national agricultural banks are manageable through standard supervisory techniques. To evaluate the condition of individual institutions, we examine loan portfolios and classify loans when it appears that repayment of the loan will require careful attention from bank management. Additionally, through examinations we evaluate the adequacy of management's systems and controls and identify areas of management weakness.

Through special training for examiners who deal primarily with agricultural banks and through quality control procedures that ensure consistency of the evaluation of agricultural credits, we have enhanced our ability to accurately assess the condition of agricultural banks. We have not, however, adopted any special examination procedures to treat problem agri- cultural loans any differently than other loans. Such measures would lead to financial statements and earnings reports that present a distorted picture of the bank's performance and health, in direct conflict with our primary mission of ensuring systemic stability.

Third, agricultural bankers, with the support and encouragement of their supervisors, are pursuing workout plans in an effort to resolve their farm borrowers' financial problems. For example, when a lender and farm

borrower in financial difficulty expect that there will ultimately be sufficient revenues to repay an outstanding debt, the debt may be restructured and additional credit extended to facilitate a return to profitability. While this in itself will not remove a particular loan from classified status, we believe such workout strategies represent a prudent banking practice when based on realistic projections of the farmer's ability to generate income. Satisfactory adherence to the restructured schedule will result in loans being removed from problem status.

Finally, we feel that such assistance could have longer-term detrimental effects on the banking system. Federal assistance could establish a precedent for other economic sectors to seek legislative relief from adverse credit conditions. Banks that have extended credit to the energy industry, the timber industry, and commercial real estate developers, for example, might seek similar legislative relief.

Such assistance would also inadvertently penalize those agricultural banks that have already marked down their loan portfolios and taken the brunt of their losses. Furthermore, it would send the wrong signal to the majority of agricultural banks that are successfully coping with the problems of the farm sector. Their incentives for carefully working their way out of problems would likely be diminished if there were a promise of government help.

Conclusion

The deteriorating condition of many agricultural banks is a result of structural changes within the nation's farm sector. It may be unrealistic to view those changes as temporary in nature and to expect asset values and commodity prices to return to the levels of the late 1970s in light of a number of developments, including a dramatic slowdown in inflation and the increased productive capacity of a number of foreign countries. The decline in farm land values reflects market pressure to restore asset values to a level that can be supported by the land's ability to generate income.

Resolution of the agricultural bank problem, therefore, is dependent upon farmers and farm lenders adjusting to the structural changes in the agricultural sector. Farm borrowers and banks are currently working together to reach mutually agreeable solutions to loan repayment difficulties. We are confident that through the current efforts of the banks, their borrowers, and their supervisors, the problems currently facing agricultural banks will continue to be manageable.

Remarks by Frank Maguire, Senior Deputy Comptroller for Legislative and Public Affairs, before the Financial Institutions' Community Development Corporation Forum, on Community Development Corporations, Washington, D.C., August 13, 1987

It is a pleasure to welcome this large and varied contingent of bankers to this conference on Community Development Corporations (CDCs). You represent national and state banks, large and small banks, and all areas of the country. Your presence here, during Washington's monsoon season, attests to the growing interest—and growing significance—which bankers attach to CDCs as vehicles to achieve specific goals in their strategic plans.

Just as your presence says something, so does our role today. We are convening this conference, together with the Federal Reserve Board (FRB), for some very specific reasons. First, our experience with bank CDCs to date has proven them to be effective tools to foster economic and community development in partnership with other local institutions. Second, we believe that today's banking and community climate provides particular incentives—incentives which I will discuss later—for banks and communities to utilize CDCs to address development needs in communities. The mounting interest in bank CDCs by bankers, the public sector, and community groups is proof of this contention. Finally, we want to encourage more banks like those represented here today to invest in CDCs; we also want to assist you in doing so.

This summarizes in a nutshell why we have convened this conference. You will hear today about the process of creating a bank CDC, the benefits of doing so, the types of activity undertaken, and the regulatory parameters for bank CDC investments. In the remainder of my remarks, I want to provide some background for these practicalities. I am going to focus first on the factors in the banking and community climate which are spurring interest in bank CDCs. Then I will discuss particular features of bank CDCs which make them particularly relevant vehicles for community development in this climate.

Why the increased interest throughout the country in bank CDCs? I see four interrelated incentives:

The first is the increasing sophistication of banks about the interrelationship between their market strategy and their community role. Bankers like you are seeing more and more that economic and housing development in your marketplace can translate into an enhanced market for their services and products. You are perceiving that your talents as traditional economic problem solvers can be transferred effectively to community economic problem solving. You have noted that CDCs, whether bank, bank holding company, or community sponsored, are effective in promoting community economic development. Operating in a highly competitive atmosphere, you are beginning to recognize that CDC investments present a unique opportunity to distinguish yourselves from your banking and nonbank competitors.

An excellent example is the Buckeye-Woodland CDC which was created in 1982 by four Cleveland banks and two corporations to stabilize a rapidly declining neighborhood and reattract investment to that neighborhood. This CDC's impact was summarized last December by Michael R. Greer, Senior Vice President of Society National Bank at an Affordable Housing Roundtable sponsored by the OCC.

For the bankers in the audience I think it is important to note that there are substantial direct benefits for the banks involved in the Buckeye-Woodland CDC. According to Greer, ". . . [T]he CDC has produced a stabilized and revitalized core neighborhood where the banks have legitimate business interests. It has protected the long-term interest that we had in the area, such as our branch banks and the outstanding loans to consumers already living in the neighborhood.

The biggest accomplishment, however, is the tremendous source of new equity value which the CDC has created within the Community. . . ."

A second example is the South Shore Bank in Chicago, which will be discussed today, which represents perhaps the most graphic example of bank growth in assets and profits resulting from neighborhood revitalization spurred by a bank holding company CDC.

This CDC has proved that banks can invest in a vehicle which can reopen legitimate and profitable credit markets previously overlooked in the community

Second are the structural changes in banking. The movement toward regional interstate banking is also producing greater awareness among bankers and their customers about the importance of maintaining and establishing a creditable community presence through concrete community commitments. At a time of accelerating consolidation and mergers, bankers and

regulators are increasingly sensitive to the importance of reaffirming bank-community links and creating a positive image in new market communities. CDC investments are increasingly viewed as a vehicle toward this end.

Third is the emerging national trend to solve economic development and housing problems through local initiatives and community joint ventures. Federal budget constraints and renewed confidence in localized solutions have created new demands and new opportunities for banks and other local institutions to work in partnership to address community problems. Bankers like you are uniquely qualified to take the lead in such initiatives because of your community credibility, your knowledge of local markets and economic conditions, and your experience and leadership in economic development. Indeed, banks have been at a forefront in developing community partnerships to address housing issues in Chicago and Boston. Increasingly, CDCs are being viewed as appropriate vehicles for implementing community joint ventures to address local economic development needs.

Finally, there are growing expectations from banks on the part of bank customers and community groups. Throughout the country, you and other bankers are becoming more aware of this growing sophistication and activity among your customers and community groups.

As a result, bankers like you are taking initiatives—initiatives which we regulators encourage and applaud—to meet community investment needs. You are finding that CDCs present one option for channelling community investments effectively and productively within your communities.

I want to stress the phrase "one option." Obviously, Community Development Corporations represent only one vehicle which banks are utilizing to foster community development and invest in community projects. Routinely, banks are using a variety of tools and techniques such as interest subsidy loan programs, Small Business Administration (SBA) guaranteed loans, and purchase of local tax exempt bond issues to fulfill these purposes.

Given your experience with these proven strategies, I would like to address my second major question. What are the particular features which make bank CDCs particularly relevant vehicles for community development?

We believe that bank CDC investments are extraordinarily flexible instruments from a number of perspectives. Banks may choose to create a CDC subsidiary or make a CDC investment in an existing entity, using a variety of mechanisms as equity or debt investors. Banks also may act singly to create a CDC or may do so in conjunction with other financial institutions, the city government, or a combination of parties. The CDC, in turn, may elect to focus on a large or small geographical area within the bank's community and to undertake one or several types of activities, ranging from housing development or small business incubators to major industrial development. It also may opt to make equity investments, to form revolving loan pools, establish syndicated projects or combine a variety of such funding strategies. These are just a few examples of how the CDC investments offer bank flexibility in addressing identified needs.

Additionally, we believe that because of its flexibility, a bank CDC is a good vehicle to implement the partnership approach and effect the concentration of resources required in the emerging new strategy for solving community economic problems. As indicated earlier, a CDC can involve a multiplicity of partners, attract diverse types of investments, and engage in a variety of activities and methods of financing. Bank sponsorship frequently is the catalyst which provides the necessary know-how and credibility to attract other investors. Further, the creation of a well-structured CDC lends itself to implementing long-term strategies required to address critical community development needs.

In Miami, Florida, there was a critical need for capital for minority owned businesses. You will hear later today how Southeast Bank, N.A. took a leadership role to involve about a dozen Florida banks, as well as other investors, to form the Business Assistance Consortium, a CDC partnership formed to address this community need.

Finally, we believe that, for the bank, a CDC or CDC investment can offer distinct opportunities and advantages. A CDC makes it possible for banks to make equity investments which fulfill a public purpose and potentially generate indirect or direct profits for the bank. The bank can combine under the CDC umbrella the gamut of community development activities previously dispersed in many departments. Creation of a CDC enables the bank to exert direct control over its community development investments, thereby minimizing or neutralizing risks, and focusing projects to conform with the bank's strategic plan.

A bank CDC investment also enables a bank to commit funds to entities and projects which meet our public purpose guidelines sponsored by other institutions without direct bank involvement in the organization and management. In Blacksburg, Virginia, for example, the National Bank of Blacksburg elected to make an invest-

ment in a CDC newly organized under the sponsorship of the county government for the purpose of fostering job creation and small business development.

During the sessions today you will hear each of these concepts discussed in greater detail and in the context of specific examples. You may forget details and examples, but I hope you will carry with you some basic thoughts for the future: The OCC strongly supports bank initiatives which respond to community needs and which have a public thrust. As Comptroller Clarke informed the Affordable Housing Roundtable attendees last December: "We want to urge banks to take the initiative in evaluating their own performance under the Community Reinvestment Act, in reaching out to work with community groups, and in using creative solutions to meet credit needs. . ." We consider CDCs excellent examples of such creative solutions. Accordingly, during the last year the agency has taken steps to make banks more aware of the CDC program. This conference, of course, represents one of the more significant initiatives in this direction. The OCC also had a CDC exhibit at the ABA's Real Estate Finance Conference earlier this year. Additionally, the OCC developed and distributed a CDC information packet. These steps are now paying off and we are already seeing an increase in national banks' inquiries regarding CDC investments.

In conclusion, we have convened this conference, in conjunction with the FRB, as an expression of our interest in CDCs and as an effort to provide information and guidance to those bankers and bank holding company representatives desiring to pursue the CDC investment option. The OCC's Customer and Industry Affairs Division, which administers the program, is ready to consult and assist national banks in every way possible. On your side of the table, we ask that you come to us with realistic and well-defined goals for your CDC investment; that you involve community leaders in your planning; and that you give advance thought to development of a viable action plan which can implement your objectives. With this level of partnership between us, I am confident that bank CDC investments will evolve into increasingly productive tools for both banks and their communities.

Statement of Dean Marriott, Senior Deputy Comptroller for Bank Supervision Operations, before the House Subcommittee on General Oversight and Investigations of the Committee on Banking, Finance and Urban Affairs, on risk-based capital requirements, Washington, D.C., April 21, 1988

Mr. Chairman and members of the subcommittee, I am pleased to have the opportunity to testify on the joint efforts of the U.S. banking agencies to develop risk-based capital standards. The Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency published a risk-based capital proposal in the *Federal Register* on March 15, 1988. Public comments are being accepted through May 13, 1988. We encourage input from Congress, the industry, and the public.

The proposal is based on the framework for international capital standards established in December 1987 by the Basle Committee on Banking Regulations and Supervisory Practices (frequently referred to as the Cooke Committee), which meets under the auspices of the Bank for International Settlements.

Efforts to develop a risk-based capital measure in the United States date back a number of years, and the three U.S. banking agencies first issued a risk-based capital proposal for public comment in 1986. A majority of the public comments on the 1986 proposal from banks expressed general support. Many respondents asserted, however, that without similar requirements for foreign competitors, the proposed requirements would put U.S. banks at a competitive disadvantage.

In light of those concerns, the U.S. agencies began working with the Bank of England on the development of a common approach. In January 1987, a joint U.S. /U.K. Risk-Based Capital Proposal was published. The scope for international convergence expanded once again when the Cooke Committee took the U.S./U.K. Proposal under consideration and addressed the possibility of expanding the agreement to include all of the countries represented on the Cooke Committee.

As a result of the Cooke Committee's efforts, an international framework, on which the current U.S. Proposal is based, was published in December of 1987. Thus, the current proposal is the culmination of several years of work to develop internationally consistent capital standards.

Because of space limitations the tables referred to herein are not reproduced. See volume 7, number 2, pages 53-56 of the Quarterly Journal

These efforts are particularly important today since advances in technology and deregulation have resulted in increasing globalization of the banking and financial markets around the world. U.S. multinational banks increasingly compete directly with banking organizations from other countries. It has thus become particularly important to develop capital standards that are internationally consistent, and that would foster fair and equitable international competition in a safe and sound environment.

We realize that the proposed risk-based capital guidelines are not likely to be perfect, and by necessity represent various compromises between the U.S. and the other 11 Cooke Committee conferees. However, we believe that the proposed guidelines offer important improvements over the current capital adequacy standard in ways that I will now describe.

Flaws in the Existing Capital Standard

The current capital standard, which requires banks to maintain primary capital of at least 5.5 percent of total assets and total capital of at least 6 percent of total assets, has several flaws.

First, it fails to formally differentiate between high risk and low risk assets. For example, U.S. Treasury obligations and loans to unrated commercial borrowers require identical capital. This problem results from the fact that both the primary and total capital ratios use the volume of total assets as a proxy for the amount of risk a bank faces. This is obviously a very crude measure of risk, since assets may vary widely in their risk characteristics.

The second flaw in the current standard is that it does not require capital against off-balance sheet activities. Off-balance sheet activities, such as standby letters of credit, have been an area of rapid growth and some expose banks to credit risk in much the same way as on-balance sheet assets. Yet, by definition, the total assets measure does not include such items

The third flaw in the existing capital standard is that neither the minimum required capital ratio nor the definition of capital is uniform internationally. The lack of a uniform definition of capital has made it difficult to compare capital levels among different countries and has led to frequent complaints about inequitable competition in international banking markets

The U.S. Proposal, like the Cooke Committee framework on which it is based, is a modest attempt to mitigate some of the shortcomings of the existing standard. The proposed guidelines make three basic improvements in the capital standard because they:

- recognize differences in the riskiness of assets by discounting capital requirements for some assets that clearly have less credit risk than others;
- recognize the risk inherent in some off-balance sheet activities by requiring that banks hold capital against them; and,
- establish a definition of capital and a minimum capital standard that are consistent internationally.

The U.S. Proposal focuses primarily on credit risk, however, a banking organization's capital base must be available to absorb losses stemming from any other kind of risk, such as foreign exchange risk, liquidity or funding risk, and interest rate risk. Bank supervisors' assessment of overall capital adequacy takes into account these other risks and involves a qualitative judgment made during an on-site bank examination. The examination involves analysis of the quality and level of earnings, the quality of loans and investments, the effectiveness of loan and investment policies, and management's overall ability to monitor and control risk. Thus, the supervisory judgment of a banking organization's capital adequacy goes far beyond a simple risk-based capital ratio.

Nevertheless, the risk-based ratio provides bankers, as well as examiners, with a useful benchmark or starting point to use in the analysis of capital adequacy. I would like to describe now in greater detail the three areas in which the U.S. Proposal differs from the existing capital standard.

Assets Are Risk Weighted

First, assets are placed into one of five categories, based primarily on perceived credit risk. To calculate a bank's minimum capital requirement, the face value of assets in each category is adjusted to reflect the relative riskiness of that category.

For example, assets in the first category—consisting of cash, reserves at the Federal Reserve, and short-term U.S. Government securities—are viewed as having essentially no credit risk and, therefore, require no capital.

Capital is required against assets in the remaining four categories: capital would be required against 10, 20, 50, or 100 percent of the asset's face value, depending on the particular category. The implication of this is, for example, that an asset with a risk weight of 10 percent would require only one-tenth the capital support required for an asset weighted 100 percent. The asset risk weights from the U.S. Proposal are presented in Table 1. Several of the asset weights are worth noting.

Broad discretion was given by the Cooke Committee on the appropriate risk weight for claims on the central government. The Committee proposed that such assets be placed into the 0, 10, or 20 percent risk categories. The U.S. Proposal assigns direct and indirect claims on the federal government to the 10 percent category. As an exception to this general rule, we are proposing that direct claims on the U.S. Government and its agencies be placed in the O percent category if they have a remaining maturity of 91 days or less. Because they lack the full faith and credit backing of the federal government, direct and indirect claims on U.S. Government-sponsored agencies, such as obligations of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, have been assigned to the 20 percent risk category, although the proposal explicitly seeks comment on the appropriate placement for government-sponsored agency securities.

The Cooke Committee also left domestic supervisors a wide choice on the weighting of domestic, non-central government debt—ranging from 0 to 50 percent. The U.S. proposal distinguishes between general obligation debt, backed by the full faith and credit of the local taxing authority, and public purpose debt which is to be paid purely out of the revenues of the project being financed. General obligations are placed in the 20 percent risk category, while other public purpose debt is in the 50 percent category. Private purpose debt of states, counties, or municipalities—such as industrial development bonds—would be placed in the 100 percent category.

In accordance with the Cooke Committee framework, short- and long-term claims on U.S. depository institutions and short-term claims on foreign banks are assigned a risk weight of 20 percent. Further, assets guaranteed by domestic banks would also be assigned a 20 percent risk weight.

Finally, although loans for owner-occupied residential real estate are assigned a 50 percent risk weight in the Cooke Committee framework, the U.S. agencies have assigned such loans to the 100 percent category. We assign them a 100 percent risk weight because we feel it is consistent with the treatment of other loans. The main forms of collateralized loans that are recognized by the proposal as deserving of special lower risk

treatment are those secured by direct or indirect claims on U.S. federal, state, or local governments. Loans without such collateral— even those to "triple A" private borrowers—do not receive lower risk weight treatment. Giving special treatment to real estate loans would be inconsistent with this approach and would add fuel to the criticism that the risk-based capital proposal is an attempt by the banking agencies to engage in credit allocation.

Off-Balance Sheet Activities Are Included

The second change from the existing capital standard is that the risk-based capital ratio takes account of the credit risk exposure that results from off-balance sheet activities. The U.S. banking agencies have followed the Cooke Committee framework in the treatment of off-balance sheet items. Because of the contingent nature of these items, the proposal has taken a two-step approach.

In the first step, the face value of each off-balance sheet instrument would be converted into an amount that permits it to be compared to an on-balance sheet loan in terms of credit risk. We refer to this quantity as the instrument's "credit-risk equivalent" and calculate it by multiplying the nominal principal amount of the off-balance sheet instrument by a so-called credit conversion factor.

For example, a standby letter of credit serving as a financial guarantee exposes a bank to the same amount of credit risk as a loan to the same customer. It would, therefore, be assigned a credit conversion factor of 100 percent. Other off-balance sheet instruments entail less credit risk and, therefore, would be assigned lower conversion factors—some as low as 0 percent.

In the second step, the credit-risk equivalent is placed into one of the five risk categories, based upon the type of instrument, obligor, collateral, or guarantee that is involved. Thus, for example, an off-balance sheet item with a credit conversion factor of 50 percent issued to an obligor who falls into the 50 percent risk category would require capital against 25 percent of the dollar amount of the item. The credit conversion factors proposed by the banking agencies are listed in Table 2.

With regard to interest and exchange rate contracts, the Cooke Committee proposed two options for incorporating the credit risk of these instruments into the risk-based capital ratio. Table 3 shows the method that the U.S. banking agencies are proposing to use.

Capital Is Redefined

The third area of change under the proposed risk-based capital standard involves the redefinition of capital. Table 4 lists the elements of capital as defined in the U.S. Proposal.

Capital instruments are placed in two tiers. Tier 1 would include common equity and minority interests in a bank's consolidated subsidiaries. This definition is more restrictive than the current definition of primary capital in that it excludes perpetual preferred stock and the allowance for loan and lease losses. Tier 2 capital would include, among other items, preferred stock, mandatory convertible securities, subordinated debt, and the allowance for loan and lease losses. Tier 2 capital elements would qualify as part of a bank's total capital base up to a maximum of 100 percent of that bank's Tier 1 capital.

Some of the elements of Tier 2, however, would be subject to additional sub-limits. These include the loan loss reserve, which would be limited to 1.25 percent of risk-weighted assets, and term subordinated debt and intermediate-term limited-life preferred stock, which would be subject to a combined limit of 50 percent of Tier 1 capital. Moreover, these latter instruments would be amortized during the final five years of their term to maturity.

Further, some assets would be deducted from capital under the proposed redefinition. These include most intangibles, majority investments in unconsolidated banking or finance subsidiaries, and reciprocal holdings of other banks' capital instruments.

Among intangible assets, purchased mortgage-servicing rights would not be deducted from capital. In addition, goodwill acquired through supervisory mergers of problem or failed banks might not be required to be deducted; this would be decided on a case-by-case basis. While the U.S. Proposal does not explicitly deduct investments in other unconsolidated subsidiaries—such as joint ventures or subsidiaries engaged in businesses other than banking or finance—such investments would be considered on a case-by-case basis, and may be deducted from capital in part or in whole.

Finally, the Cooke Committee framework allows revaluation reserves for unrecognized gains on securities holdings and on bank premises to be included in Tier 2. While in some countries such reserves are widely regarded as components of a bank's net worth, this has traditionally been neither the regulatory nor the accounting practice in the United States. The U.S. banking agencies have

therefore proposed that such reserves not be included in the regulatory definition of capital.

The Minimum Capital Requirement

In accordance with the international framework established by the Cooke Committee, a five-year transition period would be provided under the U.S. Proposal. Banks would be required to have risk-based capital ratios of at least 8 percent by year-end 1992. Half of this capital would have to consist of Tier 1 capital. The U.S. supervisory agencies would begin to phase-in the new requirements as of December 31, 1990. During the phase-in period, exceptions to the limitations on the use of Tier 2 capital instruments would be allowed. In addition, some elements of capital would be grandfathered during the transition.

The existing capital-to-total assets requirements would remain in effect at least until the end of 1990. By that time, the U.S. agencies will decide whether to operate the risk-based guidelines in tandem with a minimum capital-to-total assets ratio. Such a minimum ratio, if used, would probably be based on the new definition of capital and be set at an as yet undetermined level.

Remaining Steps in the Process

The following steps remain before the new risk-based capital standard can be put into effect. The U.S. agencies will review the comments they are currently receiving and will determine whether to recommend that changes be made in the Cooke Committee's Proposal. The Cooke Committee will meet, probably in July, to consider whether to make revisions to its proposal. It will publish a final international standard sometime thereafter. The U.S. agencies will then determine whether changes should be made to the U.S. Proposal, either because of revisions made by the Cooke Committee in its international framework, or as a result of comments received on the U.S. Proposal. The U.S. agencies will then publish the final version of the new capital guidelines, possibly by late 1988.

Conclusion

The OCC is pleased that the process of achieving both international and domestic agreement on capital standards has progressed this far. Feedback from interested parties has been an important part of that process, and in fact has led to several changes in the U.S. Proposal in the past. I would like to reiterate that we continue to value input from interested parties, including the Congress.

Remarks by Robert L. Clarke, Comptroller of the Currency, before the American Bankers Association's Stonier Graduate School of Banking, on the Office of the Comptroller of the Currency's bank failure study, Newark, Delaware, June 20, 1988

Several years ago, the American existentialist philosopher Woody Allen began a graduation speech in this way: "More than any other time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness. The other, to total extinction. Let us pray we have the wisdom to choose correctly." Allen wasn't talking to the Stonier School of Banking. But if he had been, he would merely have been echoing widely held sentiments about the banking industry.

Throughout the 1980s, the number of troubled banks, and the number of bank failures, have risen dramatically. In the Midwest and the Southwest especially, depressed conditions in agriculture, in energy, and in real estate have pummeled banks like tempests battering ships at sea.

Hundreds of banks have foundered. Hundreds more have barely weathered the storm. Yet, others have righted themselves. And thousands in America's heartland have sailed through the storms practically unharmed as a matter of course.

Over the last year, the Office of the Comptroller of the Currency (OCC) undertook a detailed study to gain a better understanding of why the performance of banks diverged so dramatically when they were faced with similar declines in their economic environments over the last decade.

We looked at three groups of banks: those that failed, similarly situated banks that experienced problems but were restored to health, and banks whose condition never deteriorated despite the problems in their local economies.

We were looking for the answers to several questions. What common characteristics and conditions were present in failed banks? Were there characteristics and conditions in common among the problem banks that rebounded, both when they were deteriorating and when they were rehabilitating themselves? What characteristics and conditions did the consistently healthy banks share? Did the characteristics and conditions differ significantly among these groups of banks? Why do many banks that operate in a depressed economy remain relatively healthy? What went wrong in the failed banks? And, most important, if we could find what went wrong in the failed banks, can anything be done about it? In other words, the big question we sought to answer was: do some banks, as a matter of uncontrollable fate, of economic determinism, face a crossroads where one path leads to despair and utter hopelessness and the other to total extinction?

The thesis I present to the Stonier School of Banking tonight is: in the vast majority of cases, banks are not the prisoners of fate—damned if they do, damned if they don't. Most often, banking performance, good and bad, is primarily the result of managerial behavior, even in depressed economic environments.

In most cases of bank performance we reviewed, specific patterns of practices within a bank itself determined its success or failure, although economic problems in the market served by the bank often played a contributing role. Our findings shouldn't come as a complete surprise.

Last January, we released the preliminary results of the first phase of our study, a phase that focused on our analysis of the common characteristics and conditions in national banks that failed over the last decade.*

Based on our preliminary findings, we concluded that, while poor economic conditions certainly make banking more difficult, the efforts of management have greater influence on success or failure.

We found that the most common characteristic of failed banks was that they were poorly managed, and by that I mean that the banks failed to establish and adhere to policies, they failed to develop managerial direction and routine that would see them through bad economic times.

In the second and final phase of our study, which I'm here to discuss tonight, we performed the same analysis on similar groups of rehabilitated and healthy banks as we did on the failed banks. The results of the second phase were to be a test of the findings in the first phase. In other words, through comparison and contrast of the three groups of banks, we sought to determine whether successful banks established and adhered to policies that would see them through bad economic times.

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*For a speech relating to the first phase of the bank failure study, see volume 7, number 1, pages 98-101 of the Quarterly Journal.

We had a theory, based on years of experience in supervising banks in a variety of geographic and economic markets, that sound operating policies and procedures would enable banks, as a general rule, to weather economic difficulties in the markets they serve. We found that our theory was valid.

Before I turn to our study's findings in detail, I want to briefly describe how we went about developing those findings.

In the first part of our study, we analyzed 171 failed national banks to identify characteristics and conditions present when these banks deteriorated. These banks were 94 percent of the national banks that failed between 1979 and 1987. Nine out of ten of these banks had assets of $100 million or less, and almost eight out of ten had assets of $50 million or less. Eighty-five percent of these banks were in our Midwestern, Southwestern, or Western supervisory districts.

We conducted the same evaluation for a sample of 51 rehabilitated banks in similar circumstances that experienced significant difficulties and recovered. By that I mean that, according to our rankings, these banks fell from being among the healthiest banks to being problem banks, and then returned again to health, during the years 1979 through 1987. We looked at them both when they were declining and when they returned to health. Again, about nine out of ten of these banks had assets of $100 million or less. Eight out of ten were located in our three western districts, and they included banks in Dallas, in Houston, and in Oklahoma City.

Finally, we evaluated a sample of 38 healthy banks facing economic problems that maintained good or superior supervisory ratings, our two highest ratings, during the same period. Again, about nine out of ten of these banks had assets of $100 million or less and eight out of ten were located in our three western districts.

In other words, the rehabilitated bank and healthy bank samples were chosen to conform as closely as possible to the failed banks in terms of location, problems in the economy, and asset size.

Using examination reports, bank histories prepared by OCC examiners, and other information provided by banks and examiners, we subjectively, and I stress the word, "subjectively," evaluated each bank's performance in eight broad categories: policy, planning, and management quality; audits, controls, and systems; asset quality; liquidity and funds management; nonfunding expenses; insider abuse; fraud; and economic environment.

Within each of the eight categories, we evaluated a number of specific characteristics to determine whether each was significantly present, marginally present, or not present at all. By evaluating these factors, it was possible to detail the particular difficulties and strengths that banks had within each of the broader categories.

Why do I stress that our study is a subjective evaluation?

First of all, the evidence we worked with was itself a compilation of subjective evaluations. Bank supervision, after all, is a judgment business. The tools in a bank examiner's kit—financial formulas, statistical sampling and so on —are intended to present the examiner with the means to measure a bank's financial condition objectively. But once the numbers are run, the examiner's own knowledge, experience, and expertise come into play in interpreting what the numbers mean. Second, we approached the evidence to write a clinical history of what went wrong, and what went right, in a large number of specific case histories in the past. Historical accounts are invariably subjective.

Furthermore, rather than trying to establish cause-and-effect, the goal of science, we were trying to discover whether there exist associations among a number of factors we reviewed and, if there do, to get some idea of how strong these associations were. Rather than seeking immutable laws of nature, we were searching for broad correlations. As a result, we don't claim that our study is "scientific" in the technical meaning of the term.

But that doesn't mean that it isn't meaningful or accurate. Just as a painting may be just as accurate and more meaningful than a photograph, we believe this study is just as accurate, and at least as meaningful, as a technically scientific study would be.

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Scientific observation is, in and of itself, no guarantee of meaning or accuracy. All that being said, what did our study find? Tonight I will describe in detail our findings in four areas: general management; loan portfolio management; the role of the chief executive officer; and fraud and abuse.

I will then discuss why some problem banks recovered while others failed, and why the continuously healthy banks stayed healthy. Finally, I will put our findings in perspective.

As I said before, management—by senior officers, by the board of directors—is key to a bank's success or failure. Managers must manage or suffer from the consequences of their failure to do so.

Now management is one of those cosmic terms that covers a multitude of virtues and skills. It includes strategic vision, a vision of where the management wants the institution to be 5 years from now or 10 years from now. It includes inspiring and motivating staff, that is to say how to get people to do what you want them to do when you want them to do it, how to take responsibility and to be accountable for it. It includes so much that it is virtually impossible to define "management" definitively. But for the purposes of our study, we didn't need a definitive definition, only a working definition. For the purposes of our study, we defined management as a process to ensure the right things are done and that things are done right.

To manage is to maintain control. To maintain control you have to make decisions. To make decisions you have to know what is going on in your institution and you have to have the means to take action when you need to: In other words, you have to know where you are, where you want to go, and how to get there. And you have to do these things day-by-day, or ensure that they are being done, or the institution will soon be out of control.

Our study found that deficiencies within boards of directors and management were the primary internal problems of problem and failed banks. We found that more than half of the failed banks had directorates that either lacked necessary banking knowledge or were uninformed or passive in their supervision of the bank's affairs. And, significantly, more than half of the rehabilitated banks had similar deficiencies as they declined into problem status.

In contrast, none of the boards of the continuously healthy banks, or of the rehabilitated banks upon their return to health, had significant deficiencies in these areas.

As I stated before, as part of our evaluation of management, we looked at the policies, controls, and systems of every bank in the study. Significantly, we found that these problems at failed banks were related to poor board or management supervision.

Most failed banks either had no loan policies, or, if they did, the policies were not followed. Most had inadequate systems to ensure compliance with internal policies or banking laws. Most had inadequate controls or supervision of key bank officers or departments. More than half had inadequate problem loan identification systems. In more than half, one dominant individual made decisions. And about half had nonexistent or poorly followed asset and liability management policies.

In general, we found that our group of rehabilitated banks had similar problems during their decline as the failed banks did. In other words, problem and failed banks consistently lacked policies, systems, and controls to guide their staffs in performing the necessary job of managing an income-producing loan portfolio.

In contrast, while healthy banks were not immune to some of the negative factors found in problem or failed banks, these detrimental conditions were less frequent or intense, and healthy banks were less likely to have them in combination.

Almost all the healthy banks had strong controls over key bank officials. Most had strong management information systems. More than half had strong problem loan identification systems. Half had strong loan policies, policies that were followed. And almost half had fully effective systems to ensure compliance with internal policies and laws.

We also looked at the loan portfolio management practices at every bank in the study. Here we found another set of problems that prevailed in failed banks, a set of problems that generally reflected overly aggressive activity, which can be described as when the management or board was excessively growth minded, or when they followed liberal credit views.

Aggressive, growth-minded behavior is not, in and of itself, a weakness. In fact, when an aggressive approach is combined with well-established policies and controls, it can be a successful strategy. But we found that when an aggressive approach is not combined with such policies and controls, there are likely to be problems.

In most of the failed banks we found that the board or management was overly aggressive to some degree; and in almost half, the boards were aggressive in a way that had had a significantly negative effect on performance.

What set of problems did we find in loan portfolio management practices? Most failed banks followed liberal lending practices; that is to say, liberal repayment terms, collection practices, or credit standards. None of the healthy banks did. More than half of the failed banks had excessive loan growth in relation to their resources to back it up: managerial ability, staff, control systems, or funding sources. Virtually none of the healthy banks did.

Almost half of the failed banks placed undue reliance on volatile liabilities, and many had problems with inadequate liquid assets as a second source of liquidity.

During their decline, the rehabilitated banks also experienced problems associated with overly aggressive

behavior, but significantly less frequently than the failed banks did.

I want to stress that, among the healthy banks, overly aggressive behavior was nearly nonexistent. This evidence indicates that overly aggressive behavior may well underlie severe problems and make recovery from those problems much less likely.

Overly aggressive behavior—for example, growth for growth's sake, or growth without the resources to back it up—is a highly risky strategy because it leaves the bank exposed when the economy turns down. In other words, when the economic tide goes out, you find who is swimming naked.

One finding from our study appears self-evident at first glance: the capability, experience, and integrity of the chief executive officer (CEO) is probably the most important determinant of the success or failure of a bank.

Our study gives us a clearer perspective of just how much that is the case: CEOs had significant weaknesses at many of the failed and problem banks. We found that almost two-thirds of the failed banks had CEOs who clearly lacked the capability, experience, or integrity necessary to make their banks successful. Most of the rest of the failed banks had CEOs who showed some signs of weakness in these areas. In the rehabilitated banks in their declining stage, more than half the CEOs had at least marginal shortcomings, and a large number evidenced significant shortcomings. By contrast, in the continuously healthy banks, there were no problems apparent with CEO experience, capability, or integrity.

It is common to compare the CEO to the captain of a ship. This comparison is a cliche because the surface similarities are so striking. But in terms of banking, the similarities go far deeper than the surface. The captain determines where the ship will go and how it will get there. That's navigation. But it is also the captain's responsibility to ensure that the ship is in optimal condition, ship shape, so captains are steeped in engineering and ship handling to understand each of a particular vessel's strengths and weaknesses. That's practical nautical expenise. Furthermore, the captain must have the knowledge of how to function in varying circumstances — calm seas and high, good weather and bad — knowledge in theory and in practice, in general for all ships and in particular for the one in his charge. That's seamanship. Finally, the captain must know the responsibilities of his crew, must make sure that they know what their responsibilities are, and must hold them accountable for doing their jobs. That's command.

The captain's skill, expertise, knowledge, and effort are the most important factors that determine whether the ship remains afloat or smashes up on the rocks; whether the ship ends up at the destination, or ends up adrift, the prisoner of currents. A captain needs tools to do the job: compass or computer for charting and remaining on course. And a captain needs frequent and complete reports from his officers to ensure that his commands are being followed, that the ship remains on course, that nothing is going wrong.

Why must a captain know so much and do so much? The captain cannot control the sea, so he must have complete control of his ship. The bank CEO has no control over the economy, so he better have control over the bank. Remember, too, that a CEO is like a ship's captain in one other important respect. Traditionally, the captain goes down with his ship.

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I would like to touch on the last major area of findings in our study: insider abuse and fraud. Insider abuse was a significant factor leading to failure in about a third of the failed banks. About a quarter of these failed banks with significant insider abuse also had significant problems involving fraud.

During their decline, about a quarter of the rehabilitated banks experienced significant insider abuse. In contrast, of the continuously healthy banks, only one had a marginal problem with fraud and another with insider abuse.

As you might expect, problems of insider abuse and fraud were often related to the lack of oversight and controls. Several conditions, found more often in failed banks that experienced significant insider abuse and fraud than in failed banks that did not, may have provided the opportunity for such problems to become significant. They included: inadequate supervision of key officers; a dominant decision maker; unwarranted concentrations of credit to one industry; and inadequate guidelines for purchasing loan participations.

Generally these conditions, with the exception of a bank's reliance on one dominant decision maker, were at worst only marginally apparent at the continuously healthy banks. Apparently, proper supervision of bank officers and formal guidelines to monitor and control lending practices also helped to limit insider abuse and fraud.

Why did some problem banks recover while others failed? In looking at the problem banks that recovered, we found that a number of factors contributed to their rehabilitation, including changes in management,

improved banking practices; changes in banking philosophy; capitalization; and improved local economic conditions. In spite of a few lingering problems found at the rehabilitated banks, their efforts to make important changes were clear. Also, the fact that rehabilitated banks—during their decline—were less likely to have an overly aggressive board of directors or to follow practices that might be judged overly aggressive worked in their favor.

Furthermore, rehabilitated banks had a much better record of compliance or partial compliance with administrative actions taken by the OCC than the failed banks did. While we took administrative actions in roughly similar percentages with the failed and rehabilitated banks, the rehabilitated banks made a serious or competent effort to meet, and succeeded in meeting, our directives more than twice as often as the failed banks did.

While a banker's job is undoubtedly easier in a strong economy, strong management and systems can prevent failure and promote recovery even during difficult economic times if management and the board of directors act quickly and positively. The evidence in our study shows that attention to and compliance with administrative actions have a positive effect on a bank's condition.

Why did the continuously healthy banks stay healthy? Our analysis showed that the banks we evaluated were not totally free of managerial shortcomings or externally generated economic problems. However, we found that these banks generally had far fewer internal difficulties—in management, in systems and controls, and so on—than the banks in the other groups. Clearly, the best way for management to weather an economic storm is to minimize internal shortcomings.

A strongly managed bank with adequate systems in place and followed is best prepared to remain profitable in bad times as well as in good times. The way to maintain a bank's health, therefore, appears to be to limit the number of shortcomings of management, the board of directors, and the policies and systems they put into place.

Although the healthy banks were not completely without weaknesses, their weaknesses were generally isolated and offset by strengths in other areas.

I can draw an imperfect analogy between a person's health and a bank's health. You are probably not doing yourself grievous harm if you have a cigar once a month or a glass of wine on Saturday night or a piece of cake on your birthday or you don't exercise quite as much as you should or you are five pounds above your optimal weight. But chances are that your patterns of behavior have left you in poor shape to weather a sudden onslaught of stress and strain if you smoke two packs of unfiltered cigarettes a day; drink a quart of gin every night; the staples of your diet are doughnuts, pizza and beer; and the last time you broke into a sweat from physical exercise was in high school gym class.

Building a strong bank, one that can survive stress and strain, requires the same commitment and attention to detail, the same conscious effort to do the right things, as building a strong body does. Or, looking at it another way, good management practice, in banking or any other business, is a mosaic of management procedures that, when isolated, may not be that meaningful but that, when fitted together with understanding and imagination, create order.

It has been said that the difference between school and real life is that in real life first you get the test, then you learn your lesson. Over the last decade, many banks have been tested. Some have passed. Others have failed. But there are lessons in all of their real life experiences for bankers everywhere.

Bankers are not in a position to exercise any great influence on the external conditions they face. Like the captain of a ship, they sail on an ever-changing sea. But, again like a ship's captain, bankers are in a position to ensure that their charge is prepared for whatever change the future may bring. Bankers are in a position to change their internal operating procedures. If bankers don't plan and prepare now to endure change, they will likely pay later.

Our study demonstrates that banks are able to remain healthy institutions throughout economic fluctuations by establishing and maintaining strong internal policies, systems, and controls. Without such policies, systems and controls, banks are more likely to succumb to external pressures.

Problem and failed banks are almost never simply the result of depressed economic conditions. There is no single, simple reason why banks get into trouble or why they don't.

There is no single panacea that will swiftly and surely transform a troubled bank into a profitable and sound institution.

Management—day-to-day management—nuts-and-bolts management—is an attitude and a series of basic, fundamental steps that, taken together, keep an institution healthy and that restore strength and profitability to those institutions that have declined.

In the evolving business of banking, the successful bankers will be those who understand the risks of the businesses in which they are engaged, who ensure the expertise of their board and management, and who establish the operating capability to handle the products and services they offer.

I would like to close by again quoting the words of the American existential philosopher Woody Allen: "Life is divided into the horrible and the miserable." For bankers, neither has to be the case. Bankers have a choice.

Statement of Robert L. Clarke, Comptroller of the Currency, before the House Committee on Ways and Means, on highly leveraged transactions, Washington, D.C., January 31, 1989

Mr. Chairman and members of the committee, I am pleased to have this opportunity to testify on the role commercial banks play in financing highly leveraged transactions (HLTs) and on the steps that the Office of the Comptroller of the Currency (OCC) is taking to bring about the prudent management of those financings.

Several highly leveraged transactions, particularly some that involve the buyout of public shareholders of corporations, have been in the headlines recently. My objective this morning is not to discuss the broad tax, competitive, and other issues concerning the role of highly leveraged transactions in the economy, which the committee is considering. Instead, my mission today is to present the perspective of the OCC as the supervisor of national banks. As such, we want bank participation in financing HLTs to be consistent with safe and sound banking practices.

Today I would like to: 1) outline the kinds of transactions on which the OCC has focused its attention; 2) describe the ways in which commercial banks participate in financing HLTs and present some data on the extent of commercial bank involvement; 3) discuss the risks associated with commercial bank participation in HLTs; and 4) discuss the OCC's methods for assessing how banks manage their HLT-associated lending. One important part of our efforts thus far is an examining circular, issued on December 14, 1988, which outlines for our bank examiners and the national banks we supervise, some important components of assessing the HLT-related lending activities of national banks.

Highly Leveraged Transactions

The most widely recognized highly leveraged transactions are leveraged buyouts (LBOs), a term that usually refers to a corporate takeover, either by the target company's managers or by outside buyers, that is financed primarily with debt. Focusing solely on leveraged buyouts, however, is too narrow a perspective. There are other highly leveraged transactions that do not involve a corporate takeover that should also be considered. Thus, the transactions in which we are interested include the following:

- Any purchase of assets or equity of a company that is financed largely by debt, including debt secured by the purchased assets or equity;
- Any financing transaction that leaves a firm with a debt-to-equity ratio that is significantly greater than is normal for the firm's industry; and,
- Any purchase of the assets or stock of a firm that employs financing that leaves the firm with relatively little unobligated cash flow and may require the liquidation of some assets to reduce the debt burden to a manageable level over the long term.

All of these transactions produce the same basic result: a substantial increase in the firm's debt relative to shareholder equity.

Because there is no satisfactory single definition of a highly leveraged transaction, there is no universal agreement about how many HLTs have taken place or the volume of debt associated with those transactions. However, estimates from different analysts are reasonably consistent and generally range between \$150 billion and \$180 billion. For example, using a private database source, the Federal Reserve Bank of Chicago counts about \$155 billion in leveraged buyouts from 1984 through 1988; in a recent study, Morgan Stanley & Co. estimated that financing for the 350 major leveraged buyouts since 1978 totaled \$166 billion; a PaineWebber study of leveraged buyouts of \$100 million or more performed since 1981 estimates total leveraged buyout financing at \$178 billion.

Commercial Bank Participation in HLTs

Role of Commercial Banks

Fundamentally, bank financing of highly leveraged transactions is not different from other types of commercial lending. The basic ingredients of a sound credit policy must be applied, including a thorough credit analysis, an analysis of cash flow projections under a variety of economic conditions, and an assessment of the competence of management. In essence, the lender must assess how the borrower plans to repay the debt—and be satisfied that it can

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Commercial banking organizations may participate in HLT financings in a number of ways. The vast majority of national bank involvement in HLTs is in the form of term loans and bridge loans—traditional banking activities. Term loans are senior debt, generally secured by the assets of the target company. As the name implies, senior debt has priority over other creditors and equity investors, and is thus the least risky form of HLT financing. In the typical highly leveraged transaction, between one-half and two-thirds of the financing may be provided by banks in the form of term loans. Bridge loans are typically short-term loans that provide financing while the other parts of the total long-term financing package are being underwritten and distributed.

Because national banks are prohibited by 12 U.S.C. 24 from holding equity securities and are limited in the types of debt securities that they may hold, banking organizations have participated to a much lesser extent, and through their bank holding company parents and affiliates, in mezzanine financing and equity financing of highly leveraged transactions. Mezzanine financing is a general term that refers to any portion of a financing package that ranks behind senior debt, but before equity, in terms of creditor standing. Examples include debt secured by a junior rather than a senior lien on the borrower's assets, and debt that is fully subordinated so that in the event of default, the creditor would receive no principal or interest payments until the senor debt is fully repaid. Included in this category of financing are high-yield, or so-called "junk" bonds. And, of course, the equity financing portion of a highly leveraged transaction consists of the common or preferred stock that is issued.

Extent of Commercial Bank Lending

At present, there is no distinction made in commercial bank call reports between highly leveraged transactions and other corporate lending. Consequently, the OCC does not have precise data concerning the total volume of HLT credits currently held by U.S. banks. However, data regarding the dollar volume of HLTs will be collected during the 1989 examination of Shared National Credits. A Shared National Credit is any loan of $20 million or more that is shared by two or more depository institutions. The Shared National Credits examination process began at the OCC in 1975; the Federal Reserve System and the FDIC joined the OCC effort shortly thereafter. Because most HLT loans are syndicated, we expect the survey of Shared National Credits to capture the large majority of HLT loans by commercial banks.

[illegible] estimates of total leveraged buyout financing [illegible] that have been published by private firms of the volume of leveraged buyout financings underwritten and held by commercial banks also vary. For example, an October 1988 survey by Prudential-Bache Securities of the 10 largest U.S. commercial banks found an aggregate LBO exposure of $18.5 billion. A November 1988 survey by PaineWebber of 28 large U.S. banks reported an aggregate exposure of $28.3 billion dollars, equal to 3.6 percent of total loans at those banks.

A broader estimate of the volume of LBO transactions underwritten by commercial banks comes from Loan Pricing Corporation, a private database service. The Loan Pricing Corporation database, which is not exhaustive, lists about 380 LBO loans at commercial banks as of December 1988, totaling slightly less than $80 billion. Those data are gathered from reports filed with the Securities and Exchange Commission by publicly held companies.

The $80 billion figure reported by the Loan Pricing Corporation represents the amount of the banks' original loan commitments. The banks reporting the commitments are usually part of a syndication group that sells participations in the financing to others, including foreign banks. Thus, the $80 billion figure does not represent the book value of LBO financing actually held by U.S. commercial banks as of December 1988; rather, it represents the volume of the commercial bank loan commitments reported to the SEC and interpreted by Loan Pricing Corporation as LBO financings.

Although these amounts are large, the total volume of LBO loan commitments reported by Loan Pricing Corporation represents less than 3 percent of the total assets of U.S. commercial banks. Moreover, involvement in highly leveraged transaction financing to date has been limited to a small number of multinational and regional banks, and, using a broad definition of HLTs, averages less than 10 percent of their loan portfolios. Based on discussions with national banks active in HLT lending, it appears that the vast majority of the largest HLT lenders restrict their holdings of loans to any particular firm involved in a HLT to a maximum of $50 million.

Potential Risks in HLT Lending By Commercial Banks

Lending to highly leveraged corporations, like any extension of credit, involves risks. The more debt a firm has, other things being equal, the more vulnerable it is to distress stemming from a decrease in its revenues. That observation has caused concern that an economic downturn or other economic shock could lead to a large number of bankruptcies among highly leveraged corporations and result in major losses to their lenders, including commercial banks.

The sensitivity of a leveraged firm's ability to service its debt under a variety of circumstances is a valid concern and one that appears to be generally recognized by those who engage in highly leveraged transactions. Many firms involved in HLTs have characteristics that reduce their vulnerability to business cycles, including low capital investment and research and development requirements, steady cash flows, and stable demand. Moreover, the firms that engage in HLTs frequently have free-standing units, often undervalued, which can be sold to reduce the debt load.

When we consider whether bank participation in HLT financing is consistent with safety and soundness principles, there are two key questions:

> First, can banks correctly evaluate the risk involved in financing a highly leveraged transaction? That is, can they accurately judge the ability of the borrower to service its debt throughout the range of business conditions the firm can be expected to face over the life of the loan?
>
> And second, are those risks acceptable, or can they be reduced to an acceptable level through risk-sharing with other banks and portfolio diversification?

The most significant source of risk in highly leveraged transactions is the possibility that competing bidders will over-value a firm's assets, and as a result, assume more debt than the firm can service. The principal protection against overlending to HLT firms is a thorough examination of the target firm's assets and earnings history by the banks involved in financing the transaction. That is essentially the process banks go through in evaluating all commercial loans, but on a much larger scale; HLT financing requires a high level of financing expertise, pricing sophistication, and expert analytical skills.

Credit risk cannot be eliminated. It can be managed, however, by carefully underwriting and by diversification. A properly managed HLT portfolio, consisting of loans to a wide variety of firms in many industries and regions can substantially reduce a bank's exposure to cyclical declines.

In addition to credit risk, banks that originate financing for highly leveraged transactions may be exposed to distribution risk. This includes the risk that the originating bank will have difficulty finding secondary buyers for HLT debt, and either be forced to offer more generous credit terms (cutting into its own returns), or be left holding more of its initial loan commitment than was intended. There are also some legal risks in connection with the distribution of this debt. For example, loan purchasers may seek recourse from the originating banks if a transaction sours.

It is difficult to estimate the magnitude of distribution risk, because the system that has arisen for syndicating and distributing HLT debt has not yet been seriously tested, either by a shortage of willing lenders or by legal challenge. Our current efforts are aimed at ensuring that banks proceed cautiously, and pay close attention to the availability of syndication resources and secondary lenders before making loan commitments.

Another risk of particular concern to the OCC is the possibility that conflicts of interest may arise when a banking company participates in more than one tier of financing in a single highly leveraged transaction. For example, it is possible that a bank holding company's equity interest in a borrower could conflict with a subsidiary bank's obligations to an entity that is purchasing senior debt of the same borrower. The OCC's examining circular on highly leveraged transactions, which I mentioned at the beginning of this statement, specifically instructs examiners to make a determination of the adequacy of a bank's procedural safeguards against such conflicts of interest.

Existing Regulatory Controls on Bank HLT Financing

Before I describe the specific steps the OCC has taken to assess how well banks manage the risks involved in financing highly leveraged transactions, it is important to note the existing regulatory and supervisory controls on the credit exposures of all national banks. The OCC regulates and supervises the risk exposure of national banks in two basic ways. First, federal statutes and regulations define permissible bank assets and lending practices. Second, we use examinations and other supervisory procedures to check compliance with these statutes and regulations, to review investment and loan policies, and to examine the quality of the assets in national bank portfolios, and to ensure that banks are valuing those assets properly on their balance sheets.

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OCC Survey of HLT Financing at Major National Banks

We believe that the risks assumed by banks engaged in HLT lending are not substantially different from risks associated with other types of bank lending. As with other types of bank lending, banks can adopt procedures to see that these risks are properly managed. We believe that we have at our disposal the means to assess how banks manage those risks. To do our job well, however, we recognize that we need a greater

familiarity with the particulars of HLT lending by national banks. In essence, we need information that will enable us to answer the questions posed earlier: do banks really understand the risks they are assuming, and are banks able to manage those risks adequately?

To gather that information, we initiated, in the spring of 1988, a study of leveraged financing activities at 16 of the largest national banks. The purpose of the study was to assess the extent and types of HLT financing by these national banks, and to see what specific policies and procedures they had in place to control their HLT exposure. A team of examiners visited each bank and, based upon a series of interviews with senior management, prepared a profile of each bank's participation in HLT financing.

Most of the banks surveyed have established limits on both their aggregate HLT exposure and on individual transactions. The banks tend to place strict limits on the amount of a given transaction they will hold for their own portfolio: they sell down their initial commitment position, using networks to redistribute portions of the transaction to other investors. The banks also reported, based on their internal credit classification system, that the credit quality of the HLT loan portfolio has generally been satisfactory to date; classified and problem loans have not been excessive, and losses have been minimal.

Although these findings were reassuring, we are concerned that the high fees and returns available on HLT loans might tempt some banks to commit funds to transactions without first developing standards for evaluating financing risks, or without placing prudent limits on their exposure to losses. The OCC's supervisory response to bank financing of highly leveraged transactions is thus taking two forms: the agency will examine the process by which national banks perform HLT financing, and it will also examine the credit quality of selected highly leveraged transactions themselves.

Supervising the Process of HLT Financing

The OCC's examination procedures focus on the adequacy of the bank's management systems and control measures. Although we perform detailed examinations of a bank's actual operations and practices when necessary, our examination philosophy is that the best way to identify self-perpetuating managerial weaknesses is through an analysis of the processes and systems a bank uses to conduct its business.

Accordingly, a bank's policies and procedures, and its control systems, are the focus of OCC Examining Circular 245 regarding Highly Leveraged Transactions. That circular, issued December 15, 1988, lists detailed examination guidelines that outline how we believe banks should, at a minimum, structure the process of financing HLTs. It was distributed not only to all OCC examination personnel, but also to the chief executive officers of all national banks.

The guidelines begin by asking whether the bank's board has adopted a written policy statement that clearly (1) defines highly leveraged transactions, (2) defines the bank's philosophy toward HLT financing, and (3) outlines the bank's objectives in providing the service. Equally important is whether the board has approved a separate lending policy that covers the process of approving and reporting HLT exposures. The guidelines note that a good lending policy will specify control mechanisms, underwriting criteria, and regular review of the HLT portfolio by line management. Examiners are also asked to evaluate the ability of management information systems to record and monitor the HLT exposure, screen the portfolio for loan concentrations by industry, and track changes in risk ratings of individual loans.

Because HLT financings are often syndicated to a large number of banks throughout the United States and the world, the OCC, pursuant to its guidelines, expects both originating and purchasing banks to adopt formal policies and procedures covering the sale and distribution and purchase of participations in such transactions. Management and the board of directors are expected to ensure full compliance with the OCC's guidelines governing asset participations and purchases as detailed in the previously mentioned OCC Banking Circular 181. They must also establish policies to review legal and regulatory issues associated with HLT financing. Examiners must assess the bank's internal review of its HLT portfolio, which, at a minimum, should include an annual review of all HLT credits as a separate portfolio, to supplement the bank's normal management control process. Further, examiners are directed to assess how the bank incorporates the risks related to HLT financing into its determination of the adequacy of the loan loss reserve.

The OCC has kept examination staff on full-time duty at the ccountry's 11 largest national banks for the last several years. That continuous presence provides us with greater knowledge of the day-to-day managerial decisions at these complex institutions than would otherwise be available. In doing so, it increases our sensitivity to the general condition of those institutions. This on-site monitoring program has increased our predictive capability in the supervision of the nation's largest banks and has quickened our response to problems at some institutions.

The OCC's permanent on-site staff, along with other senior examiners, is scheduled, over the next several

months, to start targeted examinations of the HLT lending process at the largest banks. We have also scheduled similar examinations at major regional banks.

Supervising the Credit Quality of HLT Financing

The second type of supervisory function performed by the OCC concerning bank financing of HLTs involves examining the credit quality of selected transactions.

As indicated previously, once a year, the OCC, together with the FDIC and the Federal Reserve System, performs a joint supervisory review of all loans within the system of insured depository institutions that qualify as Shared National Credits. Each Shared National Credit is reviewed at one institution—usually the agent bank—and the credit quality rating assigned by examiners is reported to all participating institutions. Those ratings are subsequently used in examinations of the participating banks, avoiding duplicate reviews of the same loan and ensuring consistent treatment of all banks participating in the credit.

We think most HLT financings currently qualify as Shared National Credits, and this year we have made minor modifications to the Shared National Credits system in order to refine bank reporting of those loans. Another modification will permit us to capture both the banks' outstandings on HLT financings as well as their total commitments.

During the credit examination of these loans, examiners will assign each loan to one of five categories: pass, special mention, substandard, doubtful, and loss. When the results are compiled into our Shared National Credit database, we will have a more detailed picture of both the quantity and the quality of HLT financing provided by banks. For example, each credit will carry a standard industrial classification code so we will be able to quantify the aggregate degree of diversification in national bank HLT portfolios. The credit ratings assigned by the examiners will also permit us to measure the credit quality of bank HLT exposures.

Conclusion

We recognize that HLT financings, if improperly managed, could expose banks to risks that are inconsistent with principles of safety and soundness, but so can other types of financing. The challenge facing bankers who engage in HLT financing is to develop policies and procedures that will enable them to assess the risks in a particular transaction accurately and to diversify the risk if they decide to participate in the transaction.

Bank supervisors must ensure that risk-taking by banks stays within prudent limits. If a bank does not have adequate lending policies or does not accurately value its loans, we will take action to make sure that they do. But bank supervisors must avoid actions that are too sweeping. Blanket restrictions on lending to highly leveraged firms, rather than allowing banks to assess potential risks and make decisions based on those assessments, would penalize sound credits along with risky ones. It could also impede bank lending to small businesses, as many small business loans involve leverage ratios similar to those in the highly publicized leveraged buyouts.

In the final analysis, we must keep in mind that HLT loans are not fundamentally different from other types of bank lending. As with any loans, some are riskier than others. The role of a commercial bank is to assess risks and decide which credits it wants to extend. Our job as bank supervisors is to ensure that those decisions are made on a sound basis.

Statement of Robert L. Clarke, Comptroller of the Currency, before the Senate Committee on Banking, Housing, and Urban Affairs on the closure of the Bank of New England, Washington, D.C., January 9, 1991

Mr. Chairman and members of the committee, I am here today at your request to discuss the events leading up to the closure of the Bank of New England, N.A. (Bank) and two affiliated banks: the Connecticut Bank and Trust Company, N.A. (Connecticut) and the Maine National Bank (Maine). The Bank had, through aggressive lending practices, built up a large concentration of real estate loans, and began to suffer substantial losses when the New England economy entered a severe downturn in 1989. Under close supervision by the Office of the Comptroller of the Currency (OCC), the Bank attempted to remedy its problems. Unfortunately, it was unable to do so, and losses continued throughout 1990. On January 6, the OCC determined that those losses had exhausted the Bank's equity capital. In consultation with the Federal Reserve Board and the Federal Deposit Insurance Corporation (FDIC), the OCC declared the Bank insolvent and appointed the FDIC as receiver. The failure of the Bank triggered the failure of its two affiliated banks, as I will explain later in my statement.

These events come at a time when the banking system and the Bank Insurance Fund are already under considerable stress. This heightens concern as to whether the Bank and its affiliates were adequately supervised. I believe the closure was properly timed and was handled appropriately by the OCC and the FDIC. This will become clear as I review the supervisory history of the Bank for the past two years, up to and including the events of the past week.

The New England Economy

During the first half of the 1980s, much of the New England region experienced an economic boom fueled by growth in high-technology manufacturing industries. One by-product of the boom was a rapid escalation in commercial and residential real estate values. The resulting increase in real estate construction served to augment and prolong the economic expansion.

The boom began to unravel after 1985, as defense cutbacks reduced demand for the region's products. The service, finance, and construction sectors of the regional economy continued to propel economic expansion for several more years, but by early 1989 the region had entered an economic downturn which has now continued for almost two years. For example, in Massachusetts, between the first quarter of 1989 and the third quarter of 1990, total manufacturing employment fell by 5.9 percent; housing starts fell by 37.8 percent, and the average price of a new single-family home fell by 7.8 percent. In some areas, commercial real estate has been substantially overbuilt, resulting in large numbers of distressed properties

The economic downturn adversely affected virtually all New England banks, but it has been particularly damaging for the Bank of New England, which aggressively pursued real estate financing during the boom. By failing to adhere to sound credit underwriting standards or to maintain a properly diversified balance sheet, the Bank exposed itself to disproportionate and ultimately unsustainable losses when the real estate market collapsed.

OCC Supervision of the Bank of New England

The OCC's awareness of problems at the Bank is not a recent development. At year-end 1987 and 1988, we conducted examinations at the Bank and at each of its affiliated banks. We have kept bank examiners at the Bank continuously since September 1989. The OCC's presence at the Bank has been substantial, numbering as many as 150 examiners at times. During the examination that began in September 1989, OCC examiners logged more than 4,000 workdays at the Bank and its affiliates. Representatives of the FDIC and the Federal Reserve System also participated in this and subsequent examinations.

The examination of the Bank's condition as of December 31, 1988 was completed in May 1989. In the examination report that was presented to the Bank, we specifically criticized certain practices of the Bank. Subsequently, on August 10, 1989, the Bank and its directors consented to a formal agreement to correct deficiencies in its real estate lending practices. The agreement directed the Bank to remedy deficiencies in loan administration, loan loss reserve adequacy, and policies for identifying problem loans; to develop a written plan for dealing with each asset that had been criticized by the OCC, and to develop a plan for maintaining adequate capital.

As is normal practice in such cases, concern over the continued deterioration in the Bank's condition led to a decision to involve OCC headquarters more directly in day-to-day supervision. In addition, an examiner from the OCC's Multinational Banking Department with

extensive experience in dealing with distressed real estate portfolios was assigned as examiner-in-charge at the Bank.

On December 7, 1989 based on its continuing review, the OCC directed the Bank and its affiliated banks to recover the fourth quarter dividends that they had paid to their parent, the Bank of New England Corporation (Corporation). The Corporation subsequently took the extraordinary step of rescinding a dividend that had been announced (although not yet paid) to its stockholders. Since that time, neither the banks nor the Corporation have made any dividend payments.

On February 26, 1990, the Bank and its directors consented to a cease and desist order with the OCC which expanded upon the provisions of the earlier formal agreement. In addition, the cease and desist order imposed numerous specific restrictions aimed at preventing the dissipation of bank assets. These included restrictions on severance pay and management contracts for the Bank's senior officers, prior OCC approval of dividend payments and other intercompany transactions, and a prohibition on further commercial real estate lending. The OCC also required the Bank to increase capital to 3 percent of assets by May 31, 1990, and to submit for OCC approval a plan outlining how the Bank would further increase its capital to comply with all applicable capital adequacy standards. Similar cease and desist orders were executed in April and May, respectively, by Connecticut and Maine and their directors. The OCC also advised the Securities and Exchange Commission that, as a result of this examination, the bank was being required to refile its third quarter call report.

Throughout this period, the Bank took a number of steps on its own to improve its condition, including some that were not required by the formal agreement with the OCC. For example, in December 1989, the Corporation raised $613 million through the sale of a leasing subsidiary and the securitization of automobile loans. The proceeds of these sales were used to improve the Bank's capital position and stabilize its liquidity. This was followed by more than $1 billion in credit card, mortgage, and other loan sales in February 1990. Despite these efforts, the condition of the Bank continued to deteriorate. On January 22, 1990, the Bank found it necessary to borrow $225 million at the Federal Reserve's discount window.

Shortly after the Corporation announced that its constituent banks had lost $1.1 billion in 1989, the chief executive officer of both the Corporation and the Bank resigned and was replaced by an interim chief executive. On [illegible], Lawrence K. Fish was elected permanent chief executive officer of the Corporation and the Bank, with the approval of the OCC. The following month, the Bank announced personnel reductions as part of a cost saving plan.

The new management team continued to implement the Corporation's asset sale and subsidiary divestiture program. These sales, along with shrinkage in the banks, resulted in the banks' assets shrinking from $32 billion in 1989 to approximately $22 billion by the time the banks were closed. In June, the Bank was able to use the proceeds of this program, in conjunction with a national certificate of deposit program, to discontinue borrowing from the Federal Reserve Bank of Boston, on which it had been depending for liquidity since January. For the past several months, the OCC has carefully monitored the progress of the recapitalization plan proposed by the Bank's new management. From July until the Bank was closed, the Corporation tried unsuccessfully to raise new equity capital. Most recently, the Corporation tried unsuccessfully to implement an exchange of its outstanding debt securities for equity. Throughout these efforts, operating losses and the continued deterioration of the Bank's real estate loan portfolio continued to erode the Bank's remaining capital.

Declaring Insolvency

The OCC's most recent examination of the Bank began in November 1990. On Thursday, January 3, in the course of that examination, representatives of the Corporation and its constituent banks met with OCC examiners to report the results of operations for the fourth quarter of 1990 and the overall condition of the Bank. The representatives stated that the Corporation expected to post an operating loss of up to $450 million for the fourth quarter, and that a loss of that magnitude would exhaust the equity capital of both the Bank and the Corporation. The OCC's examination team reviewed the data provided and determined that the Bank's equity capital was indeed exhausted.

On Friday and Saturday, after the Corporation publicly announced its anticipated fourth quarter loss, the Bank and Connecticut experienced substantial deposit outflows which threatened to cause an immediate liquidity crisis.

On Sunday, January 6, the OCC formally declared the Bank insolvent and appointed the FDIC receiver. This event, in turn, triggered the insolvency of the two affiliated banks.

As a result of the Bank's insolvency, Connecticut was unable to recover the full value of $1.484 billion in federal funds that it had loaned to the Bank. When the loss calculated by the FDIC was charged against the capital accounts of Connecticut, it was left with an

equity capital deficiency of $49 million. The OCC therefore declared Connecticut insolvent and placed it in receivership as well.

The closure of Maine was triggered by the cross-guarantee provision contained in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). Section 206(e) of FIRREA provides that an insured depository institution can be held liable for any loss which the FDIC anticipates incurring in connection with the default of a commonly controlled insured depository institution. The FDIC, after consulting with the OCC, demanded immediate payment by Maine of an amount equal to the FDIC's expected loss as receiver for the Bank. When Maine responded that it was unable to make the payment, the OCC declared it insolvent and placed it in receivership. This is the first time that the cross-guarantee provision of FIRREA has been used to close a bank.

The magnitude of the FDIC's expected loss raises an obvious question: if the OCC had closed the Bank or placed it in receivership earlier, would the expected cost to the FDIC have been less? We do not believe so. The new management installed at the Bank in March 1990 was operating the Bank in a sound manner given the condition of its balance sheet, had made substantial progress in resolving the problems identified in the cease and desist order, and was cooperating fully with the OCC. OCC examiners stationed at the Bank were monitoring the situation continuously, and Bank managers were keeping the OCC fully informed of their actions in monthly meetings with senior officials from the OCC and other banking agencies.

Furthermore, the FDIC's experience in liquidating banks has demonstrated that there is typically an immediate depreciation in asset values when an institution is placed in government receivership. Consequently, we believe that the loss to the FDIC did not increase, and may well have been reduced, due to the efforts of the new management team. These efforts included the sale of Corporation assets and the downstreaming of the sale proceeds to the Bank. Had the Bank been closed earlier, these assets would have been left behind in the Corporation and would not have been available to reduce the FDIC's eventual resolution cost. In addition, a number of the Bank's foreign exchange and interest rate positions were closed out while the Bank remained open, further reducing the potential loss to the FDIC.

Finally, closing the Bank could have imposed substantial costs on bank customers who, given the shaky condition of the local economy, could have encountered difficulties in establishing new relationships with other depository institutions. While the choice of closure methods could have mitigated these effects somewhat, a bank left in private hands is generally better able to meet the needs of the community than a bridge bank or a bank placed in receivership.

Bridge Banks

After the OCC closed the three banks and appointed the FDIC receiver, three bridge banks were established to assume the assets and liabilities of the three insolvent banks. Bridge banks, which are chartered by the OCC but are totally owned by the FDIC, are authorized by the Competitive Equality Banking Act of 1987 as a method for continuing the operation of an insolvent bank while a more permanent solution is worked out. The bridge banks were capitalized by the FDIC and opened for business as usual on January 7. The FDIC has agreed to provide assistance to facilitate their acquisition in the near future by qualified institutions.

All deposits of the Bank, Connecticut, and Maine, including those in excess of the $100,000 insurance limit, were transferred to the bridge banks and are fully protected. Also protected are federal funds sold to the banks by unaffiliated institutions, liabilities to trade creditors and employees, and foreign exchange and interest rate swaps and other qualified financial contracts. Other unsubordinated creditors of the banks will share "pro rata" with the FDIC in the proceeds of receivership. The bridge banks did not, however, assume any of the liabilities of the parent holding company. The Corporation's equity in the banks has been wiped out, and Corporation bondholders and creditors will share "pro rata" in receivership proceeds.

The FDIC chose to protect uninsured depositors in each of the three banks, and to protect some other uninsured bank creditors (but not holding company creditors), in order to provide stability to the New England economy at a time when it is already struggling to emerge from a regional downturn and shaken by the failure of the private insurance system insuring 45 depository institutions in Rhode Island. A further loss of confidence in the U.S. banking system could have induced additional bank failures which would have cost the FDIC more than it would have saved by limiting coverage to insured deposits.

Conclusions

Although current attention naturally focuses on the supervisory events of the last few days, I want to stress that the OCC supervised the Bank intensively long before its insolvency. Under the OCC's supervision, the Bank installed new management, embarked on a program of asset sales and cost reductions to stabilize the bank, suspended dividends, and pursued a variety of

avenues for recapitalizing the Bank, all of which contributed to reducing the estimated loss to the FDIC. These efforts to salvage the Bank ultimately failed in large part due to the length and severity of the economic downturn in New England, which caused continued deterioration in the Bank's portfolio and made it impossible for the Bank to reverse the series of operating losses that ultimately led to its insolvency. When these efforts failed and the Bank exhausted its equity capital, we closed it.

Response by Robert L. Clarke to a General Accounting Office Report on the Bank of New England, September 16, 1991

After the Bank of New England (BNE) banks failed on January 6, 1991, the Office of the Comptroller of the Currency (OCC) testified four times on this matter before the House and Senate Banking Committees. In all four hearings, OCC representatives acknowledged shortcomings in the agency's supervision of Bank of New England during the 1980s.

As soon as OCC identified these problems at BNE, the agency began taking steps, starting in later 1989, to prevent similar problems from occurring again. These actions included:

- Annual Operating Plan. In the fall of 1990, the OCC issued a supervision plan for 1991 requiring full scope examinations, with an emphasis on reviewing asset quality, in all banks with more than $1 billion in assets and all problem banks. These banks account for more than 80 percent of the assets supervised by the OCC. In addition, every national bank receives an annual examination report and a meeting between examiners and the bank's board of directors. The OCC is currently preparing its supervision operating plan for 1992.

- OCC Actions to Follow Up on Bank Problems. The OCC began making greater use of formal and informal enforcement actions to ensure that banks act to correct their problems. In 1990, the OCC took 559 enforcement actions against national banks and bankers, 35 percent more than the 415 actions in 1989.

- Examination Report and Board Meeting. The OCC is revising its examination reports and the format for its meetings with bank boards of directors to ensure that bank directors and management clearly understand examination results. At a minimum, directors of every national bank must understand: problems uncovered during the examination, actions recommended by OCC to correct those problems, and deadlines for corrective action by the bank.

- Peer Review Program. To ensure that OCC supervision policies and priorities are consistently followed throughout the country, the OCC has instituted an annual peer review program in which teams of examiners review a sample of examinations in each OCC district. This quality assurance program was piloted in 1991 and will be fully operational in 1992.

Management Changes. In the 1980s, management in the Northeastern District did not communicate strongly enough to field examiners at BNE and other banks OCC concerns about potential real estate problems in the Northeast. They also failed to make sure that problems identified in examinations were clearly communicated to BNE management, and that examiners followed up to make sure problems were corrected.

Accordingly, in early 1990, OCC brought in a new Deputy Comptroller for the Northeastern District, who assembled a new management team. She has appointed new directors for the Boston and New York field offices, a new director for bank supervision, and a new director for regional bank supervision. The Northeastern District has also hired additional credit examiners to augment its examination force.

Index to Speeches and Testimony Presented on Behalf of the Office of the Comptroller of the Currency 1981-1991

Topic	Speaker	Forum	Date	Page
		Pilot Issue, 1981		
U.S. economy in 1981	John G. Heimann	Hampshire College	1/22/81	13
Export trading companies	John G. Heimann	Senate Committee on Banking, Housing, and Urban Affairs[1]	2/17/81	16
Adjustable rate mortgages	Cantwell F. Muckenfuss, III	SBC	4/7/81	20
U.S. banking in 1981	John G. Heimann	Boston University/ Boston Bar Association	4/10/81	25
U.S. banking in 1981/ OCC supervision in 1981	John G. Heimann	SBC	4/28/81	28
General Accounting Office (GAO) report on consolidating the federal bank examination force	Charles E. Lord	House Committee on Banking, Finance and Urban Affairs[2]	6/4/81	42
Competition among financial institutions	Charles E. Lord	National Association of Federal Credit Unions	7/14/81	45
		Volume 1, Number 1		
Supervising trust departments	Dean E. Miller	National Trust Conference	2/17/81	68
Supervising trust departments	Donald Johnson	Connecticut Bankers Association	5/12/81	70
Preemption of state usury ceilings	Jo Ann S. Barefoot	Senate Committee on Banking, Housing, and Urban Affairs	7/21/81	35

[1] *Hereinafter SBC. The reference includes testimony presented at subcommittee and full committee levels.*
[2] *Hereinafter HBC. The reference includes testimony presented at subcommittee and full committee levels.*

Topic	Speaker	Forum	Date	Page
		Volume 1, Number 1 (continued)		
Bank Secrecy Act	Edmund G. Zito	House Committee on Banking, Finance and Urban Affairs	7/23/81	37
Banks and the economy	Charles E. Lord	Governor's Banking Conference	9/9/81	40
Adjustable rate mortgages	Cantwell F. Muckenfuss, III	HBC	9/22/81	42
Bank deregulation bills	Charles E. Lord	SBC	10/30/81	51
		Volume 1, Number 2		
U.S. bank involvement in Poland	C.T. Conover	Senate Committee on Agriculture	3/12/82	15
Challenges for independent bankers	C.T. Conover	Independent Bankers Association of America[3]	3/17/82	16
Shared EFT networks	Raija Bettauer	Electronic Banking Conference	3/28/82	18
		Volume 1, Number 3		
Banks and the economy	C.T. Conover	Association of Reserve City Bankers[4]	4/5/82	17
New supervisory approach	Paul M. Homan	Conference of State Bank Supervisors[5]	4/19/82	20
Bank and thrift deregulation bills (Garn-St Germain)	C.T. Conover	SBC	5/26/82	22
Penn Square Bank	C.T. Conover	HBC	7/15/82	24
Penn Square Bank	C.T. Conover	House Subcommittee on Commerce, Consumer and Monetary Affairs[6]	7/16/82	28

[3] [illegible]
[4] [illegible]
[5] [illegible]
[6] [illegible]

Topic	Speaker	Forum	Date	Page
Volume 1, Number 4				
Bank Secrecy Act	Karen J. Wilson	HBC	7/13/82	15
Penn Square Bank	Clifton A. Poole	HBC	8/16/82	16
Foreign owned U.S. banks	Doyle L. Arnold	CCMA	9/30/82	18
Bank mergers	Richard V. Fitzgerald	Conference on Legal Problems of Bank Regulation	9/23/82	27
Bank disclosure	C.T. Conover	SEC Major Issues Conference	10/7/82	29
Condition of banks in 1982	C.T. Conover	National Bankers Association	10/15/82	31
Volume 2, Number 1				
Penn Square Bank	Doyle L. Arnold	Georgetown University Bankers Forum	10/1/82	37
The OCC in 1983	C.T. Conover	American Bankers Association[7]	10/19/82	39
Bank deregulation	Doyle L. Arnold	Western Savings and Loan Conference	10/21/82	42
Issues for CFOs	C.T. Conover	ABA Chief Financial Officers Seminar	11/12/82	46
What a bank holding should be	C.T. Conover	Association of Bank Holding Companies[8]	11/19/82	50
CPAs and banks	C.T. Conover	American Institute of CPAs	12/2/82	55
Penn Square Bank	C.T. Conover	SBC	12/10/82	58
Volume 2, Number 2				
Bank deregulation	C.T. Conover	Stanford/Berkeley Business School Alumni Association	2/15/83	15
LDC debt	C.T. Conover	SBC	2/17/83	18
United American Bank (UAB)	H. Joe Selby	CCMA	3/15/83	20

[7] *Hereinafter ABA*
[8] *Hereinafter ABHC*

Topic	Speaker	Forum	Date	Page
Volume 2, Number 2 (continued)				
LDC debt	C.T. Conover	SBC	4/11/83	22
Preemption of state usury ceilings	C.T. Conover	SBC	4/12/83	24
Nonbank banks	Doyle L. Arnold	ABA	4/13/83	25
Volume 2, Number 3				
LDC debt	C.T. Conover	HBC	4/21/83	17
Nonbank banks	C.T. Conover	SBC	4/27/83	25
Domestic lending in 1982	C.T. Conover	ARCB	5/10/83	30
Offshore shell banks	Robert B. Serino	Senate Permanent Subcommittee on Investigations	5/24/83	33
OCC enforcement	Robert B. Serino	CCMA	6/28/83	37
Bank deregulation	C.T. Conover	Spanish Association of Private Banks	7/6/83	41
Volume 2, Number 4				
Trust department deregulation	Dean E. Miller	Texas Bankers Association	5/19/83	13
Legal framework of financial institutions	Doyle L. Arnold	CCMA	7/21/83	17
Bank deregulation bills	C.T. Conover	SBC	9/14/83	22
Bank deregulation and bank customers	C.T. Conover	Town Hall, Los Angeles, California	9/21/83	25
Bank deregulation and bank lobbying	C.T. Conover	ABA	10/10/83	28
Volume 3, Number 1				
Trust department deregulation	Donald R. Johnson	Advanced Trust Seminar	10/13/83	43
Bank deregulation and bank supervision	Doyle L. Arnold	Financial Times Conference	10/25/83	48
Brokered deposits	C.T. Conover	HBC	10/27/83	51
Bank deregulation	Brian W. Smith	New York County Bar Association	1/11/84	54
Bank [illegible]	Doyle L. Arnold	Small Business Legislative Council	1/12/84	58

Topic	*Speaker*	*Forum*	*Date*	*Page*
		Volume 3, Number 2		
Bank deregulation and bank customers	C.T. Conover	Women in Housing and Finance	1/17/84	7
Bank deregulation	C.T. Conover	Oklahoma Bankers Association	2/8/84	9
Brokered deposits	C.T. Conover	ABA Leadership Conference	2/16/84	12
Bank deregulation	Brian W. Smith	MasterCard Annual Meeting	2/24/84	13
Brokered deposits, Bush task force	C.T. Conover	Foreign Banking in America Conference	3/6/84	18
Brokered deposits	C.T. Conover	CCMA	3/14/84	20
Bank deregulation	C.T. Conover	SBC	3/21/84	24
Bank deregulation	C.T. Conover	ARCB	4/3/84	33
Delayed funds availability	C.T. Conover	HBC	4/4/84	35
		Volume 3, Number 3		
Duties of bank boards of directors	C.T. Conover	57th Assembly of Bank Directors	4/13/84	13
Bank deregulation	C.T. Conover	Financial Executives Institute	4/26/84	15
Bank deregulation and bank lobbying	C.T. Conover	ABA	4/30/84	18
OCC enforcement	C.T. Conover	CCMA	5/3/84	21
Bank strategic plans	Richard V. Fitzgerald	National Brokerage Conference	5/30/84	44
Interstate banking	C.T. Conover	Boston University School of Law	6/1/84	47
Bank deregulation	C.T. Conover	Rutgers University	6/6/84	50
Nonbank banks	C.T. Conover	HBC	6/12/84	53
Trust department deregulation	Dean E. Miller	Campbell University	6/12/84	54
Bank Secrecy Act	Robert B. Serino	HBC	6/20/84	58
Bank deregulation and bank customers	C.T. Conover	The Consumer and and Financial Services Conference	6/28/84	61

Topic	Speaker	Forum	Date	Page
		Volume 3, Number 4		
Banks and insurance	James E. Boland	Conference of Insurance Legislators	8/25/84	13
OCC supervision	C.T. Conover	University of San Francisco School of Law	9/13/84	15
ATM network bills	Michael A. Mancusi	SBC	9/19/84	18
Continental Illinois National Bank	C.T. Conover	HBC	9/19/84	20
Banks and insurance	James E. Boland	National Association of Mutual Insurance Companies	9/26/84	36
		Volume 4, Number 1		
OCC supervision	C.T. Conover	ABA	10/24/84	35
Commercial lending	Michael A. Mancusi	Robert Morris Association	10/31/84	38
OCC supervision	Richard V. Fitzgerald	Louisiana Bankers Association	11/2/84	40
Trust department deregulation	Donald R. Johnson	59th Assembly of Bank Directors	11/9/84	44
Strategic planning for savings and loans	C.T. Conover	National Council of Savings Institutions	12/4/84	49
Benefits of external audits	C.T. Conover	California CPA Foundation	1/14/85	52
		Volume 4, Number 2		
Strategic planning for savings and loans	C.T. Conover	California League of Savings Institutions	2/25/85	11
Agricultural lending	John F. Downey	Senate Judiciary Committee	3/24/85	14
Bank deregulation Bush task force	C.T. Conover	CCMA	3/27/85	17
Bank Secrecy Act/ Bank of Boston	C.T. Conover	HBC	4/3/85	19
OCC supervision	H. Joe Selby	Bank Auditors Conference	4/15/85	27
Mortgage-backed securities	Michael Patriarca	HBC	4/16/85	30

Topic	*Speaker*	*Forum*	*Date*	*Page*
		Volume 4, Number 3		
Bank deregulation worldwide	Robert R. Bench	Pace University	3/13/85	15
Bank deregulation	C.T. Conover	New York University	4/13/85	18
Bank Secrecy Act	C.T. Conover	House Judiciary Committee	4/16/85	22
Nonbank banks	C.T. Conover	HBC	4/18/85	28
Regional interstate banking	Jonathan Fiechter	HBC	4/25/85	32
Reflections on his term in office	C.T. Conover	ARCB	4/29/85	34
Bank concentration of risk	Robert R. Bench	Arab Bankers Association	5/7/85	37
Bank deregulation	H. Joe Selby	SBC	5/8/85	40
U.S. government securities market	H. Joe Selby	CCMA	5/15/85	43
Bank deregulation	Janice A. Booker	National Center for Small Communities	5/22/85	45
OCC regulations on bank guarantees	Ford Barrett	Seminar on Off-balance Sheet Lending	5/30/85	48
OCC views on bank safety and soundness	H. Joe Selby	Conference on Deposit Insurane Reform	6/7/85	56
OCC views on retail banking	Michael A. Mancusi	OCC Conference on Retail Banking	6/27/85	58
Brokered deposits	H. Joe Selby	HBC	7/16/85	60
		Volume 4, Number 4		
OCC supervisory approach	H. Joe Selby	SBC	7/23/85	15
Golden Pacific National Bank	H. Joe Selby	HBC	8/1/85	21
Condition of national banks in 1984	Michael Patriarca	HBC	9/11/85	32
Community Development Corporations	H. Joe Selby	Conference on Community Economic Development	9/12/85	42

Topic	*Speaker*	*Forum*	*Date*	*Page*
Volume 5, Number 1				
Risk-based capital	Jonathan Fiechter	Conference on Bank Capital Adequacy	10/28/85	35
OCC supervision	H. Joe Selby	Swiss-American Chamber of Commerce	11/4/85	37
Farm credit crisis	Craig M. Stirnweis	Senate Committee on the Judiciary	11/12/85	41
Farm credit crisis	Jonathan Fiechter	HBC	11/21/85	43
Real estate appraisals	John F. Downey	CCMA	12/12/85	45
Volume 5, Number 2				
Impressions of the new Comptroller of the Currency	Robert L. Clarke	Women in Housing and Finance	1/28/86	11
Bank deregulation/ deposit insurance reform	Robert L. Clarke	SBC	3/4/86	12
Role of bank directors	Michael Patriarca	65th Assembly for Bank Directors	3/8/86	18
Farm credit crisis	Robert L. Clarke	SBC	3/11/86	20
Role of independent bankers	Robert L. Clarke	IBAA	3/12/86	26
Farm credit crisis	Robert L. Clarke	Restructuring the Bank Industry Conference	3/13/86	30
Bank deregulation	Robert L. Clarke	Houston Club	3/20/86	33
Energy lending crisis	Jonathan Fiechter	Senate Cmmittee on Energy and Natural Resources	3/25/86	37
Bank deregulation	Michael Patriarca	University of Pennsylvania	3/26/86	40
Asset-backed securities	Robert L. Clarke	ARCB	4/7/86	42
Farm credit crisis	John F. Downey	House Agriculture Committee	4/9/86	44
Bank deregulation and bank supervision	Robert L. Clarke	CSBS	4/14/86	55

Topic	*Speaker*	*Forum*	*Date*	*Page*
		Volume 6, Number 1		
International competition in banking	Robert L. Clarke	ABA	10/27/86	33
OCC bank insurance initiatives	Ford Barrett	Third Annual Banks in Insurance Comference	11/6/86	36
Condition of national banks	Robert L. Clarke	Houston Rotary Club	11/13/86	42
Bank deregulation	Richard Fitzgerald	Exchequer Club	11/19/86	46
Views on bank supervision	Dana H. Cook	Peat Marwick Conference	12/9/86	48
Condition of the S&L industry	Robert L. Clarke	Federal Home Loan Bank of San Francisco Conference	12/11/86	52
		Volume 6, Number 2		
Views on bank supervision	Robert L. Clarke	Federal Reserve Bank of Atlanta	1/8/87	9
U.S. banking policy	Robert L. Clarke	Lombard Association	2/11/87	13
Debt-equity swaps	Robert R. Bench	Euromoney Debt/Equity Conference	3/12/87	17
Consumer disclosure bills	Frank Maguire	IBAA	4/1/87	19
LDC debt	Robert R. Bench	SBC	4/2/87	21
Nonbank banks	Robert L. Clarke	IBAA	4/3/87	26
		Volume 6, Number 3		
Bank holding company reform bill	Robert L. Clarke	ARCB	5/4/87	15
Condition of national banks in 1986	Robert L. Clarke	SBC	5/21/87	18
OCC's compliance program	Robert J. Herrmann	Southeastern District Compliance Seminar	6/9/87	25
Bank Secrecy Act	Robert B. Serino	HBC	6/9/87	28
Capital forebearance	Robert L. Clarke	Arthur Young Seminar	6/18/87	36

Topic	*Speaker*	*Forum*	*Date*	*Page*
Volume 6, Number 4				
OCC's compliance program	Robert L. Clarke	Atlanta OCC Compliance Conference	7/9/87	11
OCC bank insurance initiatives	Ford Barrett	American Bar Association	8/10/87	13
Community Development Corporations	Frank Maguire	Financial Institutions CDC Forum	8/13/87	16
Role of national bank directors	Robert L. Clarke	Assembly for Bank Directors	9/6/87	18
CRA compliance	Janice A. Booker	ABA 1987 National Conference for Compliance	9/22/87	22
Bank deregulation	Robert L. Clarke	House Committee on Energy and Commerce	10/14/87	25
Volume 7, Number 1				
Bank lobbying	Robert L. Clarke	ABA	10/20/87	51
Bank deregulation	Robert L. Clarke	HBC	10/28/87	54
OCC's compliance program	Robert L. Clarke	Community Rights and the Banking Industry Conference	11/13/87	64
Insider abuse	Robert L. Clarke	CCMA	11/19/87	67
Bank deregulation	Robert L. Clarke	SBC	12/3/87	84
Benefits of bank deregulation to consumers	Robert L. Clarke	Consumer Federation of America	12/11/87	91
Bank deregulation	Robert L. Clarke	Utah Bankers Association Forum	1/5/88	94
OCC bank failure study	Robert L. Clarke	Exchequer Club	1/20/88	98
Volume 7, Number 2				
Bank lobbying	Robert L. Clarke	ARCB	2/2/88	15
Continental Illinois/ First Options	Emory W. Rushton	House Committee on Energy and Commerce	2/3/88	17
Bank lobbying	Robert L. Clarke	ABA National Trust Conference	2/22/88	20
Deposit insurance reform	Robert L. Clarke	National Council of Savings Institutions	2/24/88	23

Topic	Speaker	Forum	Date	Page
Volume 7, Number 2 (continued)				
Bank lobbying	Robert L. Clarke	ABA National Conference for Community Bankers	2/27/88	25
Duties of bank boards and management	Robert L. Clarke	IBAA	3/15/88	28
Future of banking	J. Michael Shepherd	James Madison University	3/15/88	31
Real estate appraisals	William J. Stolte	CCMA	3/15/88	35
CRA compliance	Robert L. Clarke	SBC	3/23/88	37
Risk-based capital	J. Michael Shepherd	ABHC	3/25/88	49
Volume 7, Number 3				
Bank deregulation	Robert L. Clarke	Boston University	4/19/88	33
Risk-based capital	Dean Marriott	HBC	4/21/88	36
Banking and insurance	Robert L. Clarke	House Energy and Commerce Committee	5/12/88	39
Risk-based capital	Robert L. Clarke	International Financial Conference	5/17/88	43
Condition of national banks in 1987	Robert L. Clarke	SBC	5/25/88	46
OCC bank failure study	Robert L. Clarke	ABA Stonier Graduate School of Banking	6/20/88	57
Volume 7, Number 4				
CRA reform bills	Robert L. Clarke	SBC	9/8/88	19
Banking and insurance	Robert L. Clarke	House Committee on Energy and Commerce	9/9/88	26
Banking and insurance	Robert L. Clarke	House Committee on the Judiciary	9/14/88	29
International competition in banking	Edwin H. Clock	Institute for International Research	9/14/88	33
Bank lobbying	Robert L. Clarke	ABA	10/10/88	36

Topic	Speaker	Forum	Date	Page
		Volume 8, Number 1		
Real estate lending	Robert L. Clarke	ABHC	11/17/88	55
Condition of national banks in 1987	J. Michael Shepherd	Bank Council Forum	12/5/88	58
LDC debt	Robert L. Clarke	HBC	1/5/89	63
		Volume 8, Number 2		
Highly leveraged transactions	Robert L. Clarke	House Committee on Ways and Means	1/31/89	23
OCC supervision in 1989	Robert L. Clarke	Credit Union National Association	2/6/89	28
Europe 1992	Edwin H. Clock	California Council for International trade	2/7/89	31
Emergency S&L bills (FIRREA)	Robert L. Clarke	SBC	2/28/89	35
OCC bank insolvency rule	Robert L. Clarke	IBAA	3/1/89	42
Emergency S&L bills (FIRREA)	Robert L. Clarke	National Center on Financial Services	3/3/89	46
OCC supervision and and compensation	Robert L. Clarke	HBC	3/22/89	49
Risk-based capital	Robert L. Clarke	Washington Forum	4/4/89	61
		Volume 8, Number 3		
OCC chartering policy	Robert L. Clarke	ARCB	4/10/89	23
Emergency S&L bills (FIRREA)	Robert L. Clarke	New York Bankers Association	5/8/89	26
Risk-based capital	Robert L. Clarke	Texas Bankers Association	5/11/89	29
Brokered deposits	Robert L. Clarke	HBC	5/17/89	32
Emergency S&L bills (FIRREA)	Robert L. Clarke	Florida Bankers Association	5/19/89	36
Community Development Corporations	Robert L. Clarke	Maryland Bankers Association	5/22/89	39
Bank flood insurance compliance	John H. McDowell	HBC	5/31/89	43

Volume 8, Number 3 (continued)

Topic	*Speaker*	*Forum*	*Date*	*Page*
Fair housing	Robert L. Clarke	OCC Conference on Fair Lending	6/15/89	44
LDC debt	Robert J. Herrmann	HBC	6/27/89	47
CRA compliance	John H. McDowell	SBC	7/31/89	52

Volume 8, Number 4

Topic	*Speaker*	*Forum*	*Date*	*Page*
Farmer Mac	Donald G. Coonley	HBC	9/12/89	15
OCC supervision	Robert L. Clarke	OCC Regional Bank Directors Supervision	9/14/89	18
OCC supervision	Robert L. Clarke	HBC	9/19/89	22
Europe 1992	Robert L. Clarke	HBC	9/26/89	27
Risk-based capital	Robert L. Clarke	Business & Law Forum	10/2/89	33
Europe 1992	Robert L. Clarke	ABA	10/17/89	36

Volume 9, Number 1

Topic	*Speaker*	*Forum*	*Date*	*Page*
OCC compliance program	Robert J. Herrmann	SBC	10/24/89	59
OCC supervision	Robert L. Clarke	Assembly of Bank Directors	11/3/89	69
Highly leveraged transactions	Robert L. Clarke	Seminar on the Junk Bond Market	11/20/89	73
Risk-based capital	J. Michael Shepherd	International Financial Institutions Conference	11/29/89	76
CRA compliance	Robert L. Clarke	Consumer Bankers Association	12/1/89	80

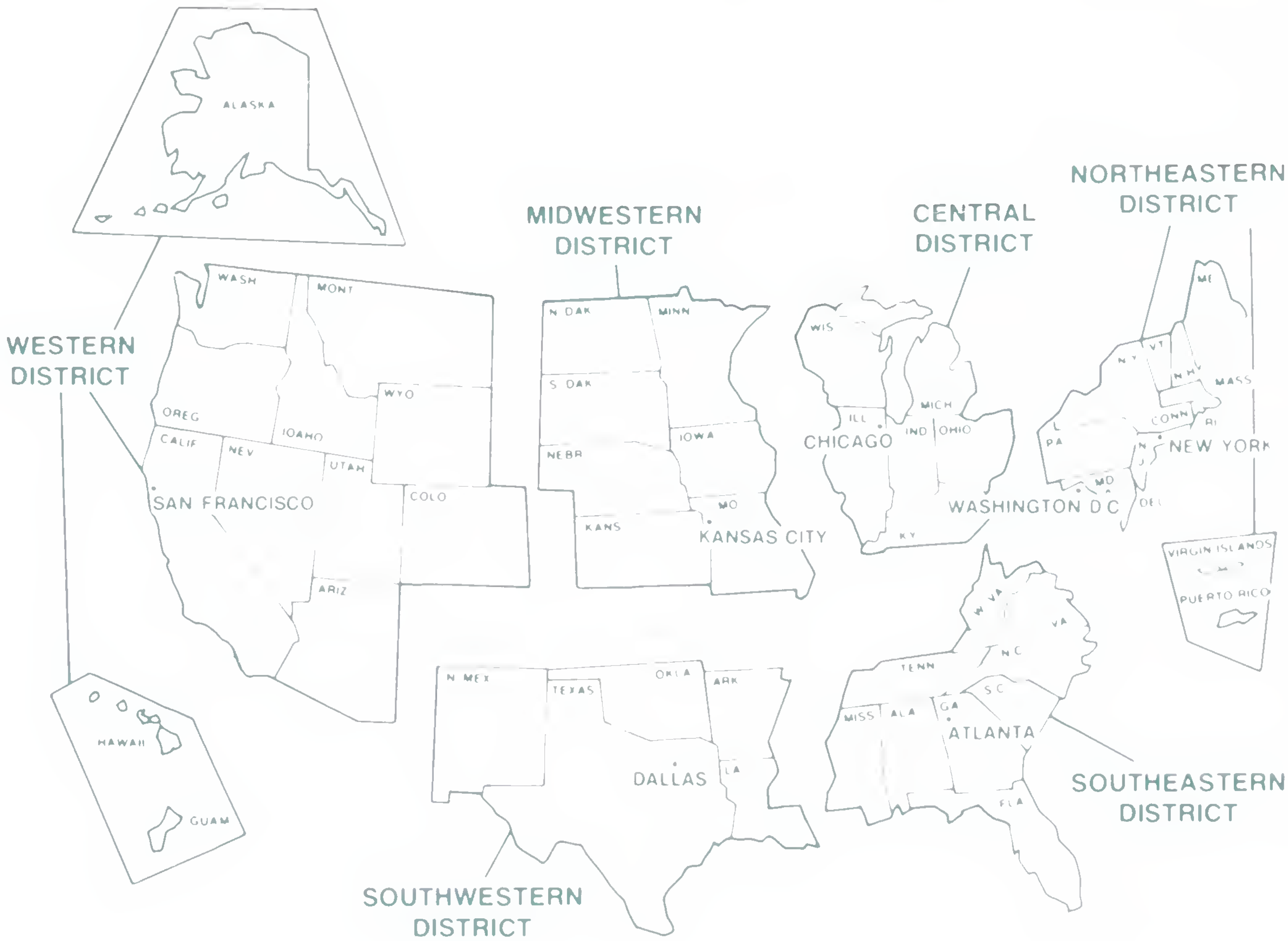
Volume 9, Number 2

Topic	*Speaker*	*Forum*	*Date*	*Page*
Trends in U.S. banking	Robert L. Clarke	Institute of International Bankers	1/8/90	19
U.S. banking abroad	Robert L. Clarke	New York State Bankers Association	1/25/90	22
Real estate lending	Robert L. Clarke	National Council of Savings Institutions	2/28/90	24
Agricultural lending	Robert L. Clarke	IBAA	3/10/90	27
[illegible]	Robert L. Clarke	HBC	3/14/90	32

Topic	Speaker	Forum	Date	Page
		Volume 9, Number 4		
Bank deregulation	Robert L. Clarke	SBC	7/31/90	25
Real estate lending	Robert L. Clarke	HBC	5/19/90	35
Risk-based capital	Robert L. Clarke	SBC	9/15/90	40
Deposit insurance	Robert L. Clarke	HBC	9/27/90	45
		Volume 10, Number 1		
Collective investment funds	Robert L. Clarke	House Energy and Commerce Committee	10/4/90	51
Mark-to-market accounting	Robert L. Clarke	American Institute of CPAs	11/8/90	55
U.S. operations of foreign banks	Stephen R. Steinbrink	HBC	10/9/90	59
Freedom National Bank	Fred D. Finke	HBC	12/18/90	61
		Volume 10, Number 2		
Bank of New England	Robert L. Clarke	SBC	1/9/91	31
OCC supervision in 1990	Robert L. Clarke	New York State Bankers Association	1/31/91	35
Bank deregulation	Robert L. Clarke	HBC	2/28/91	37
Bank accounting disclosure	Susan F. Krause	Women in Housing and Finance	2/21/91	47
		Volume 10, Number 3		
Bank deregulation	Robert L. Clarke	SBC	4/23/91	17
Bank deregulation	Robert L. Clarke	HBC	4/30/91	25
Deposit insurance	Robert L. Clarke	HBC	5/9/91	35
Madison National Bank	Robert L. Clarke	HBC	5/31/91	39
Supervising problem banks	Jon K. Hartzell	Caribbean Banking Supervisors	5/10/91	45

Topic	Speaker	Forum	Date	Page
		Volume 10, Number 4		
Reassessing bank supervision	Robert L. Clarke	Consumer Bankers Association	9/23/91	13
Bank mergers	Robert L. Clarke	HBC	9/24/91	17
Reconfirmation testimony	Robert L. Clarke	SBC	9/26/91	23
Asset-backed securities	Donald G. Coonley	HBC	7/31/91	27
Real estate lending	Donald G. Coonley	CCMA	9/16/91	31
		Volume 11, Number 1		
National banks in the U.S.	William P. Bowden, Jr.	International Law Institute Capital Markets Conference	11/11/91	53
Bank Mergers	Randall J. Miller	Senate Apporpriations Committee	12/4/91	63

Index, Special Anniversary Issue



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